



Partnerships and LLCs: Death or Retirement of a Partner

Course #33202C

Taxes

2 Credit Hours

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PARTNERSHIPS AND LLCs: DEATH OR RETIREMENT OF A PARTNER

This course covers the tax treatment of payments made to retiring or deceased partners under Code Sections 736 and 737. It explains the distinction between capital and ordinary income, goodwill considerations, installment payments, and when capital is a material income-producing factor. The course also highlights key differences between partnership and S corporation treatment, helping professionals navigate complex retirement and liquidation scenarios effectively.

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

Partnerships and LLCs: Death or Retirement of a Partner

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify scenarios in which Code Sec. 736 and Code Sec. 737 would apply.

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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DEATH OR RETIREMENT OF A PARTNER

Objective

After completing, you should be able to:

- Identify scenarios in which Code Sec. 736 and Code Sec. 737 would apply.

¶201 INTRODUCTION

When a partner voluntarily or involuntarily discontinues his or her participation in a partnership, there are several available alternatives that put the partner in substantially the same economic position but have different tax consequences:

1. The partner can sell his or her interest to one or more remaining partners and/or to an unrelated party;
2. The partnership can liquidate the partner's interest in the partnership; or
3. The partnership itself can liquidate.

Tax planning most often involves a choice between the first and second alternatives if the business is to be continued without interruption. This course covers the tax consequences when a partnership continues but a partner's interest is terminated not by sale but by receipt of a liquidating distribution or series of distributions from the partnership. The tax rules governing these circumstances are found in Code Sec. 736. Note that although the title of Code Sec. 736 refers to "retiring" or "deceased" partners, the rules apply to *any* liquidating distribution received by a partner.¹ The following table contains a brief comparison of the tax consequences of a partner's retirement by a continuing partnership through a liquidation versus a cross-purchase.

Liquidation by Partnership	Sale to Other Partner(s)
1. Partnership makes payments to retiring partner (or deceased partner's successor in interest).	1. Partner(s) make payments to retiring partner.
2. Difference between tax basis and FMV of distributed property (other than cash) not taxed until sold by distributee partner.	2. Cash and FMV of property received treated as sales proceeds. Difference between proceeds and partnership interest tax basis is realized gain.

¹ Reg. §1.736-1(a)(ii) provides that a "partner retires when he ceases to be a partner under local law." The regulation does not qualify the term "partner" (e.g., it does not say "a retiring partner is not deemed to retire until he ceases to be a partner under local law") and it contains no additional requirements. Rather, it defines the phrase "retiring partner" as a partner who has ceased to be a partner under local law.

Liquidation by Partnership	Sale to Other Partner(s)
3. Installment payments for share of partnership property not taxed until proceeds exceed outside basis (however, may elect to prorate basis).	3. All installment payments taxed. Outside basis is prorated and applied against each payment.
4. Can produce both capital gain and ordinary income for retiring partner.	4. Usually produces capital gain for retiring partner—unless collapsible partnership rules apply (Code Sec. 751(a)).
5. Can often be structured so some of the payments are deductible by the partnership.	5. Payments increase purchasing partner's basis in his or her interest and may result in a Code Sec. 754 step-up, but payments are usually not immediately deductible by the purchasing partner.
6. Not considered to be a sale or exchange that can terminate the partnership under Code Sec. 708.	6. The sale of 50% or more of the partnership's capital and profits interests within a 12-month period terminates the partnership under Code Sec. 708.
7. Installment payments are not subject to the OID rules (<i>i.e.</i> , the payments can include no interest or below-market interest).	7. Any deferred payments must provide for "adequate" interest or interest will be imputed under the OID rules.

LLC Observation



The statute, legislative history and regulations are silent with respect to which members, if any, of an LLC are considered general partners for Code Sec. 736 purposes.²

In general, payments made in liquidation of the interest of a retiring partner or a deceased partner will be treated according to the normal rules for partnership distributions, to the extent these payments are made for the partner's interest in partnership property.³ The valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will generally be regarded as correct.⁴ These payments made for the retiring partner's interest in partnership property are commonly referred to as "Code Sec. 736(b) payments." Any distributions in excess of the partner's interest in partnership property will be treated as either a distributive share of partnership income or as a guaranteed payment, and are referred to as "Code Sec. 736(a) payments."

2. In 1997, the IRS issued proposed regulations addressing the classification of LLC members as limited vs. general partners for purposes of the self-employment tax (Prop. Reg. § 1.1402(a)-2). Congress reacted by prohibiting the IRS from issuing further regulations on this subject before July 1, 1998. No further regulations have yet been issued.

3. Code Sec. 736(b)(1).

4. Reg. § 1.736-1(b)(1).

If the amounts of Code Sec. 736(a) payments are based on the income of the partnership, they are treated as a distributive share of partnership income, and will reduce the amount of the other partners' distributive shares.⁵ As distributive shares, the character of the resulting income to the retiring partner will depend on its character to the partnership. If the amounts of Code Sec. 736(a) payments are *not* based on the income of the partnership (if they are fixed, for example), they are treated as guaranteed payments.⁶ As such, they are ordinary income to the retiring partner, and create an ordinary deduction for the partnership.

Example 2-1



Partner A of the equal ABC Partnership retires from the partnership on December 31 of last year, when her basis in her partnership interest is \$150,000. The partnership will pay her a total of \$300,000 to retire her partnership interest this year. The total fair market value of partnership property is \$600,000, and the partnership and A agree that her share is equal to one-third of that amount, or \$200,000. Thus, the first \$200,000 to be received by A will be classified as a Code Sec. 736(b) payment (received in exchange for A's share of partnership property). Code Sec. 736(b) payments are treated as distributions. Recall that A's tax basis in the partnership interest was \$150,000; thus, A will recognize a \$50,000 capital gain on receipt of the Code Sec. 736(b) payment. If the partnership owns inventory or unrealized receivables, part or all of the \$50,000 might be characterized as ordinary income under Code Sec. 751.

The remaining \$100,000 to be received by A will be treated as a guaranteed payment (since it is fixed in amount), and will result in ordinary income to A and an ordinary deduction to the partnership.

If the retiring partner (or deceased partner's successor in interest) receives payments that are not fixed in amount, these variable payments will first be treated as payments in exchange for the retiring partner's interest in partnership property under Code Sec. 736(b) to the extent of the value of her interest in partnership property. Any payments in excess of the partner's share of the value of partnership property are treated as payments under Code Sec. 736(a).⁷

5. Code Sec. 736(a)(1).

6. Code Sec. 736(a)(2).

7. Reg. § 1.736-1(b)(5)(ii).