PacificCPE

COURSE
33202D

Partnership Taxation: Death, Retirement, and Liquidating Distributions

When a partner dies or retires, the tax consequences can be complex and easy to mishandle. This course walks through the rules governing liquidating payments, including how partnerships and LLCs handle buyouts, what happens when interests are transferred at death, and how sales to remaining partners are structured and taxed. Practical LLC-specific observations are woven throughout, making this chapter especially useful for practitioners who regularly advise clients on ownership transitions and succession planning.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

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

Copyright Notice

© 2026 Pacific CPE, LP. All rights reserved.

The materials in this course — including the text, illustrations, exhibits, examples, exam questions, and review questions — are the copyrighted property of Pacific CPE, LP. No portion of this course may be reproduced, stored in a retrieval system, distributed, or transmitted in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise) without the prior written permission of Pacific CPE, LP, except for the personal, non-commercial use of the registered learner.

Pacific CPE, LP grants the registered learner a single-seat, non-transferable license to access this course for the purpose of completing the associated continuing professional education credit. Account credentials may not be shared. Group access requires a separate enterprise license.

This course is provided "as is" for educational purposes. While Pacific CPE, LP makes a reasonable effort to ensure the content is current and accurate, the materials should not be relied upon as a substitute for professional advice. Pacific CPE, LP disclaims all liability for any error, omission, or loss arising from the use of, or reliance on, the course content.

Questions about reproduction, licensing, or use of these materials should be directed to support@pacificcpe.com.

Publication Date: September 2025

TABLE OF CONTENTS

CHAPTER 01

Death Or Retirement Of A Partner 4

1.01 201 Introduction 4

1.02 .01 When Is Capital A Material Income-Producing Factor? 15

1.03 .04 Payments For Retiring Service Partner'S Share Of Goodwill—Code Sec. 736(A) Or (B) 20

1.04 .07 Accounting For A Series Of Payments 24

1.05 .10 Eff ect Of Code Sec. 754 Election 32

1.06 204 S Corporation Comparison 34

Test Your Knowledge 40

Final Exam Copy 56

Glossary 54

Index .....

Chapter 1: DEATH OR RETIREMENT OF A PARTNER

Chapter Objective

After completing this chapter, 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 chapter 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.
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.e., 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

Thestatute, legislativehist ory and regulations are silent with respectto which members, if any, of an LLC are considered general partners for Code Sec. [2] 736 purposes.

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." 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 Aagreethat her shareis equal toone-thirdof that amount, or$200,000. Thus, thefirst$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).

Example 2-2

Partner D of the equal DEF Partnership retires from the partnership on December 31 of last year, when her basis in her partnership interest was $200,000. The partnership will pay her a fixed amount of $300,000 to retire her partnership interest this year. In addition, she will also receive a payment equal to one-sixth of partnership income for the current year and the next two years. Partnership income for the current year and the next two years turns out to be $120,000 each year. The total fair market value of partnership property is $720,000, and the partnership and D agree that her share is equal to one-third of that amount, or $240,000.

Of the $300,000 current year fixed payment, $240,000 is a Code Sec. 736(b) payment (in exchange for D's share of partnership property), and will be treated as a distribution. Since D's basis in the partnership interest is only $200,000, the Code Sec. 736(b) payment will trigger a capital gain in the amount of $40,000. If the partnership owns inventory or unrealized receivables part or all of the $40,000 might actually be characterized as ordinary income under Code Sec. 751, depending on the amount of D's share of ordinary income.

The other $60,000 of the $300,000 fixed payment is a Code Sec. 736(a) payment, and will be treated as a guaranteed payment (since it is fixed), taxable as ordinary income to D (and deductible by the partnership).

D's one-sixth share of partnership income over the next three years will be classified as a Code Sec. 736(a) payment, and will be treated as a distributive share of partnership income (since the amount is based on partnership income). The character of each payment will depend on the character of the income earned by the partnership.

Instead of the above rules, the allocation of each annual payment between Code Sec. 736(a) and (b) can be made in any manner agreed to by all the remaining partners and the withdrawing partner or her successor in interest, provided that the total amount allocated to property under Code Sec. 736(b) does not exceed the fair market value of the retiring partner's share of property at the date of death or retirement. [8]

If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the fraction of each fixed payment that is treated as a distribution under Code Sec. 736(b) for the taxable year will equal the total fixed payments under Code Sec. 736(b) divided by the total fixed payments under both Code Sec. 736(a) and (b). The balance, if any, of the fixed amount received in the same taxable year will be treated as a distributive share or a guaranteed payment

under Code Sec. 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount classified as a distribution under Code Sec. 736(b) in the following year or years.

Example 2-3

Retiring partner W, whoisentitledto anannualpayment of$6,000 for tenyears for his interest in partnership property, received only $3,500 last year. This year, he received $10,000. Of this amount, $8,500 ($6,000 plus $2,500 from last year) is treated as a distribution under Code Sec. 736(b); the remaining $1,500 will be treated as a payment under Code Sec. [9] 736(a).

Example 2-4

Partner D of the equal DEF Partnership retired from the partnership on December 31 of last year, when her basis in her partnership interest was $200,000. The partnership agreed to pay her a fixed amount of $100,000 each year for three years (beginning in the current year) to retire her partnership interest. In addition, she will also receive a payment equal to one-sixth of partnership income for the current year and the next two years. Partnership income for the current year and the next two years turns out to be $120,000 each year. The total fair market value of partnership property is $720,000, and the partnership and D agree that her share is equal to one-third of this amount, or $240,000.

Of the $300,000 in fixed payments to be received over the next three years, $240,000 will be Code Sec. 736(b) payments. Thus, 80% of each fixed $100,000 payment ($240,000 Code Sec. 736(b) payments/total fixed payments) will be treated as a Code Sec. 736(b) payment. The first two fixed payments will therefore result in an $80,000 ($100,000 × 80%) return of capital each year (reducing D's tax basis in the partnership interest to $40,000). The third $100,000 payment will result in a $40,000 return of capital (her remaining basis in the partnership interest) and a $40,000 capital gain ($80,000 Code Sec. 736(b) payment − $40,000 return of capital). If the partnership owns inventory or unrealized receivables part or all of the $40,000 might actually be characterized as ordinary income under Code Sec. 751.

The remaining 20% ($20,000 of each payment) will be treated as a Code Sec. 736(a) payment, taxable to D as a guaranteed payment (because these payments are fixed). D's share of the partnership's income for each of the next three years will also be Code Sec. 736(a) payments, but will be treated as distributive shares of partnership income, rather than guaranteed payments, since the amounts are based on partnership income. Thecharacterof these payments will dependonthechar acterof the income earned that year by the partnership.

The amount of any payments under Code Sec. 736(a) will be included in the income of the retiring partner for his or her taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct the payment as a guaranteed payment. This is consistent with the payments' treatment as distributive shares or guaranteed payments. On the other hand, payments under Code Sec. 736(b) will be taken into account by the retiring partner in his or her taxable year in which the payments are made. This treatment is consistent with the treatment of these payments as distributions. [10]