Adjustments of a Retiring or Deceased Partner

Retiring or Deceased Partner

When a retiring or deceased partner's interest in a partnership is completely liquidated, payments to the partner (or the decedent's successor-in-interest) are allocated under IRC Sec. 736. The rules determine how much of the payments apply to ordinary income items. **Note:** These rules do not apply upon a complete liquidation of a partnership.

IRC Sec. 736(a). Distributive share of partnership income or guaranteed payments. Taxed as ordinary income. Includes any payment not classified as a Section 736(b) payment.

IRC Sec. 736(b). Payments made in exchange for partner's ownership interest in capital assets. A partnership's arm's-length valuation of Section 736(b) property generally will be accepted as valid by the IRS [Reg. 1.736-1(b)(1)].

Special rule—unrealized receivables and goodwill. If the retiring or deceased partner was a general partner, and capital is not a material income-producing factor for the partnership, gains on goodwill and unrealized receivables generally are classified as Section 736(a) payments. Gain is therefore taxed as ordinary income. *Exception for goodwill:* If the amount of payment for goodwill is specified in the partnership agreement, it will remain as Section 736(b) property. See *Sales and Exchanges of Pass-Through Business Entity Interests* for information about unrealized receivables. Also see Reg. 1.736-1.

Example:
Ed is a 25% general partner in MPI Partnership. Capital is not a material income-producing factor in MPI. The partnership assets are:

Assets	*Adjusted Basis*	*FMV*
Cash	$ 5,000	$ 5,000
Unrealized receivables	4,000	6,000
Section 1231 asset	3,000	7,000
Totals	$ 12,000	$ 18,000

Ed receives $4,500 in complete liquidation of his interest in the partnership ($18,000 × 25%). The amount is allocated as follows:

Section 736(a) payment (ordinary income). Ed's share of gain on unrealized receivables is $500 ($6,000 FMV of unrealized receivables minus $4,000 adjusted basis of unrealized receivables = $2,000 × 25% = $500).

Section 736(b) payment. Ed's share of other assets is $4,000 ($5,000 FMV of cash + $4,000 adjusted basis of unrealized receivables + $7,000 FMV of Section 1231 asset = $16,000 × 25% = $4,000). Under IRC Sec. 736(b), $4,000 is considered a distribution in exchange for partnership property.

Net investment income tax (NIIT). For purposes of the 3.8% NIIT, liquidating payments to a retiring or deceased partner's successor-in-interest are treated as follows [Prop. Reg. 1.1411-4(g)(11)]:

- Section 736(a)(1) (distributive share) payments are determined with regard to partnership's income, treated as a distributive share of such and taken into account in computing NII in a manner consistent with the item's character and treatment. Section 736(a)(2) (guaranteed) payments are not determined with regard to the partnership's income and treated as a guaranteed payment. These payments are included in NII as gain from the disposition of a partnership interest to the extent allocable to the partnership's unrealized receivables [see *Unrealized receivables and inventory items (hot assets)*] and goodwill.
- Section 736(b) payments are taken into account as NII as net gain or loss from the disposition of property. See *Net Investment Income Tax*.

Liability Relief

When a partner is relieved of liabilities upon liquidation of a partner's interest, the liabilities assumed by the partnership are treated as a distribution of money to the partner [IRC Sec. 752(b)].

Example:
Herb has a 10% interest in Palace Manor, a limited partnership owning residential rental property. Herb's limited partnership interest is liquidated as of December 31, 20XI. The partnership balance sheet prior to the liquidation is as follows:

Assets		*Adjusted Basis*		*FMV*
Cash	$	100,000	$	100,000
Land and building		700,000		800,000
Accumulated depreciation (SL)	(	300,000)		0
	$	500,000	$	900,000
Liabilities and Capital				
Mortgage payable	$	600,000	$	600,000
Partners' equity (deficit)	(	100,000)		300,000
	$	500,000	$	900,000

Assume the mortgage is qualified nonrecourse debt. Herb's adjusted basis in his partnership interest is calculated as follows:

Tax capital account ($100,000) × 10%)	($	10,000)
Herb's share of partnership debt		60,000
Herb's adjusted basis in partnership	$	50,000

Assume the partnership agrees to give Herb $10,000 in exchange for his partnership interest. Herb's total liquidation distribution equals $70,000 ($10,000 cash + $60,000 liability relief). Herb's gain under IRC Sec. 736(b) is $20,000 ($70,000 distribution − $50,000 adjusted basis).

Reporting Deceased Partner's K-1 Items

The year of a partnership closes with respect to a partner whose entire interest in the partnership terminates whether by death, liquidation or otherwise.

Note: Under these rules, the tax year is closed only for purposes of computing the partnership items of the retiring or deceased partner. The tax year of the partnership does not close [IRC Sec. 706(c)(1)].

Tax Period	Distributive Share	Self-Employment Income
Partnership year ending on partner's date of death	Decedent's final income tax return	Decedent's final income tax return
Partnership year ending after partner's date of death	Tax return of partner's estate or successor in interest	No SE tax on estate return

Final Return

When a partnership terminates as discussed at *Termination of a Partnership*), it ends for federal income tax purposes. The final year is a short tax year if the partnership termination date is not on the last day of the partnership's tax year. Form 1065 must be filed for the short period, which is the period from the beginning of the tax year through the date of termination. The return is due by the 15th day of the third month following the termination (excluding extensions).

Final tax return of partnership:

- The final return box on page 1, Form 1065, must be checked.
- Balance of any unamortized deferred start-up costs, organizational costs or Section 197 intangibles, can be deducted in full on the final return to the extent that they qualify as a loss from the business.
- Capital account on each partner's Schedule K-1 should be zero at the end of the year.
- Balance sheet should show zero balances at the end of the year, as should the total assets box on page 1, Form 1065.

Unlike corporations, there is no special form used to notify the IRS that the business has ended. However, each partner's Schedule K-1 should have a detailed explanation of all distributions made to the partner in liquidation of his interest.

Termination of a Partnership

The TCJA repealed the partnership technical termination rules under former IRC Sec. 708(b)(1)(B), which provided that a partnership terminated if there was a sale or exchange of 50% or more of the total interest in partnership capital and profits within any 12-month period.

A partnership is considered terminated when business activities or financial operations are no longer carried on by any of its partners [IRC Sec. 708(b)(1)].

Partnership Reorganizations

Under IRC Sec. 708(b)(2), a merger or consolidation of two or more partnerships into a single partnership or a division of a single partnership into two or more partnerships generally will have no tax consequences, provided all newly formed partnerships are owned by partners who owned more than a 50% interest in the capital and profits of the old partnership(s).