DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
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SUBJECT: Measuring Gain or Loss from Sale of Partnership Interest

This Field Service Advice responds to your memorandum dated
Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Partnership =
X =
Y =

$a =
$b =
$c =
$d =

Date 1 =
Date 2 =

Year 1 =
Year 7 =

ISSUES:

1. When Taxpayer inherits a one-sixth interest in Partnership in Year 1 and sells the partnership interest in Year 7, how is Taxpayer's adjusted basis in the partnership interest determined for purposes of measuring gain or loss from the sale?

2. When Taxpayer sells the partnership interest in Year 7, should Taxpayer include in the amount realized Taxpayer's share of partnership liabilities assumed by the purchasing partner?

CONCLUSIONS:

1. Taxpayer's adjusted basis is determined by figuring Taxpayer's initial basis in the partnership interest under section 742, an amount equal to the fair market value of the inherited partnership interest increased by decedent's share of partnership liabilities, both measured as of the date of decedent's death or the alternate valuation date, and then adjusting the initial basis in the interim years in accordance with sections 705 and 752.

2. When the partnership interest was sold, Taxpayer realized an amount equal to the money received from the purchaser as well as Taxpayer's share of partnership liabilities assumed by the purchaser.

FACTS:

Taxpayer inherited a one-sixth general partnership interest in Partnership on Date 1, Year 1 from the estate of X. The value of the one-sixth partnership interest on the date of X's death, as reported on the estate tax return, was $a. According to the revenue agent's report, on the date of X's death, her share of partnership liabilities was $b.

Taxpayer sold the one-sixth interest in Partnership to Y on Date 2, Year 7, for $c. Under the sale agreement between Taxpayer and Y, Y agreed to assume Taxpayer's share of partnership liabilities. At the date of sale, Taxpayer's share of partnership liabilities was $d. In calculating the gain or loss from the sale, Taxpayer included the allocable share of partnership liabilities in the adjusted basis of the partnership interest, but Taxpayer did not include the amount of partnership liabilities assumed by Y in the amount realized.

LAW AND ANALYSIS

ISSUE 1: Adjusted Basis in Partnership Interest

The starting point for ascertaining the adjusted basis of Taxpayer's partnership interest on the date of sale is to determine the initial basis of the partnership interest in Taxpayer's hands. Section 742 of the Internal Revenue Code states that the basis of an interest in a partnership acquired other than by contribution, is determined under part II of subchapter O. Section 1014, in turn, provides that the basis in property acquired from a decedent is equal to the fair market value of the property on the date of decedent's death. Treas. Reg. § 1.742-1 clarifies, that with regard to inheritance of a partnership interest:

> The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent under section 691.

Thus, Taxpayer has an initial basis in the partnership interest equal to the fair market value of the partnership interest increased by the decedent's share of partnership liabilities ($a + $b), both valued on the date of death of X.[1]

Adjustments to Taxpayer's basis in her partnership interest in the ensuing years should be made in accordance with section 705 and section 752(a) and (b). Section 705(a)(1) provides, in pertinent part, that a partner's adjusted basis in the partnership interest is increased by the partner's share of the taxable income of the partnership and the partner's share of tax exempt income. Section 705(a)(2), provides, in pertinent part, that a partner's adjusted basis in the partnership interest is decreased by any distributions made to the partner by the partnership, the partner's share of any net loss reported from partnership operations and the partner's share of any expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

Section 752(a) provides that an increase in a partner's share of partnership liabilities is treated as a contribution of cash by that partner. In combination with section 722, section 752(a) has the effect of increasing the partner's adjusted basis in a partnership interest by the amount of the increase in liabilities. Conversely,

[1]For the sake of convenience, this memorandum assumes that X's share of liabilities on the date of X's death in Year 1 equals Taxpayer's share of partnership liabilities on the schedule K-1 prepared and filed for Year 1, and that no part of the fair market value of the partnership interest was attributable to items constituting income with respect to decedent.

section 752(b) provides that a reduction in partnership liabilities is treated as a distribution of money to the partner by the partnership. In combination with 705(a)(2), section 752(b) has the effect of decreasing the partner's adjusted basis in a partnership interest by the amount of the reduction in liabilities.

Thus, Taxpayer's basis in the partnership interest in this case should be adjusted upward and downward in accordance with the rules under section 705 and 752 above outlined for the period Taxpayer held the interest in Partnership.

ISSUE 2: Determination of Gain or Loss on Sale of Partnership Interest

Section 741 provides that gain or loss from the sale or exchange of a partnership interest will be capital, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items). Section 752(d) provides that liabilities involved in a sale or exchange of a partnership interest "shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." Section 1001 provides rules for determining the gain or loss on the sale or other disposition of property. Under section 1001(a), gain or loss is determined by the difference between the amount realized and the adjusted basis of the partnership interest. Treas. Reg. 1.741-1(a) incorporates the rule of section 1001(a) specifically in relation to the sale or exchange of a partnership interest, stating in pertinent part:

> The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705.

The rules for calculating a partner's adjusted basis in a partnership interest are discussed above in the analysis of the first issue. In order to measure the gain or loss from the sale of Taxpayer's interest in Partnership, we next must determine the amount realized from the sale.

Section 1001(b) defines "amount realized" as the "sum of any money received plus the fair market value of the property (other than money) received." Further, "[w]hen encumbered property is sold or otherwise disposed of and the purchaser assumes the mortgage, the associated extinguishment of the mortgagor's obligation to repay is accounted for in the computation of the amount realized." Commissioner v. Tufts, 461 U.S. 300, 308 (1983). Under this principle, partnership liabilities assumed by a purchaser are included in the amount realized on the sale. Treas. Reg. 1.752-1(h) incorporates the principle in Tufts, providing:

> If a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder. For example, if a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of $250, the seller realizes $1,000 on the transaction.

Thus, we conclude that Taxpayer realized not only the amount received from Y, but also the reduction in Taxpayer's share of partnership liabilities ($c + $d) when the partnership interest was sold to the purchaser.[2] Taxpayer will subtract the adjusted basis from the amount realized to determine the gain or loss on the sale of the partnership interest, and, except to the extent section 751 applies, the gain or loss will be capital in nature.

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[2]The mere existence of a negative capital account does not create a liability to be factored into the selling partner's capital gain on the sale of his partnership interest when the purchaser assumes all of the selling partner's liabilities attendant to the partnership. If the selling partner is subject to an unconditional and legally enforceable obligation to repay the deficit in his capital account and the withdrawals giving rise to the deficit represent loans made by the partnership to the partner in a capacity other than as a member of the partnership, then the release from liability is treated as a distribution of money to the partner. Rev. Rul. 73-301, 1973-2 C.B. 215 (clarifying Rev. Rul. 57-318, 1957-2 C.B. 362).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

By: ______________________________

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