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TAX MANAGEMENT INC.
WASHINGTON, D.C.

MEMORANDUM

Understanding and Using 'Partnership Redemptions' in the Context of §1(h)

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Major References:

I.R.C. §1(h); Regs. §1.1(h)-1(b).

INTRODUCTION

Section 311 of the Taxpayer Relief Act of 1997 (TRA '97)[2] made a number of important changes to the Code. Chief among these was a restructuring of the maximum rates applicable to long term capital gains.

In general, TRA '97 reduced the "maximum" rate on capital gains from 28%[3] to 20%.[4] However, apparently,[5] Congress was concerned that these lowered rates should not be applicable to all classes of long term capital gains. One of the classes of long term capital gain that was ineligible for this special treatment is that attributable to the depreciation of improved real property. Section 1250, of course, has long converted gain on the sale of such property from capital gains rates to ordinary income rates to the extent that the depreciation on such property had exceeded the depreciation permitted under the straight-line method. Rather than choosing to expand the recapture rules under §1250, which would have been another way of denying the reduced capital gains rates to this type of gain, Congress chose to create a separate tax of long term capital gain for this sort of property, known as "unrecaptured §1250 gain," and mandated that a maximum rate of 25% would apply to this gain.

With this new class of long term capital gain comes at least some ambiguity, which may present planning opportunities for well advised taxpayers when depreciable real estate is held in partnership solution, especially since the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA)[6] reduced the 20% "maximum" capital gains rate set by TRA '97 to 15%.[7] How long the maximum capital gains rates will remain this way is a matter of conjecture, but so long as they do a full 10% of tax costs are at stake in 2004 in determining whether the unrecaptured §1250 gain rules apply.

In the case of a partnership, implementing regulations[8] indicate that "unrecaptured §1250 gain" is to be determined at the partnership level and then flowed through to the partners when partnership property is sold or when a partner's interest in the partnership is sold. The same regulations indicate that they do not apply when a partner sells his or her interest to the partnership in a "redemption" rather than to outside parties.[9] This memorandum explores the origins for the general treatment of unrecaptured §1250 gain and discusses the planning opportunity that appears to exist for those that hold depreciable real property in a partnership.

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The author gratefully thanks John Smolke, C.P.A., Peterson Sullivan PLLC, Seattle, WA for his comments regarding this article. Any errors or omissions, of course, are solely those of the author.

[2] P.L. 105-34.

[3] Pre-1997 TRA §1(h)(1)(B)(2). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[4] Pre-2003 Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) §1(h)(1)(C).

[5] We say "apparently" because although TRA '97 created the rate differential this article discusses, there is a dearth of language in the legislative history as to *why the* rate differential was born, and we are left to infer that Congress simply viewed the rate and timing arbitrages that depreciable real estate can produce as simply too good of a deal when the maximum capital gains rate is at 20%.

[6] P.L. 108-27.

[7] §(1)(h)(1)(C).

[8] Regs. §1.1(h)-1(b)(3)(ii).

[9] *Id.* (last sentence).

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ANALYSIS

Prior to TRA '97, so long as a taxpayer limited himself or herself to straight-line depreciation of real property, and then sold that property at a gain, a favorable tax rate arbitrage was present: depreciation deductions reduced ordinary income, while eventual sale gain was taxed at capital gains rate. It was perhaps not quite as good as §1231, where net sale gains for a year are capital and any net sale losses for a year are ordinary, but the depreciation of real property nonetheless was likely to produce for most taxpayers a satisfactory situation given the rate differential between ordinary and capital gain income and the implicit value of upfront deductions versus back end income.

The Evolution of §1(h) Since TRA '97

Before beginning a more detailed review of the 25% gain rate rules, some historical comment is in order. TRA '97 rewrote §1(h) to provide for a 20% maximum capital gains rate, subject to a special 25% maximum rate on unrecaptured §1250 gain. The 20% maximum capital gains rate was contained in revised §1(h)(1)(B), while the special 25% maximum rate was contained in §1(h)(6). TRA '97 also added a related provision, §1(h)(11), providing that the Treasury Department was to promulgate regulations to apply revised §1(h) (including the 25% rule) to pass-thru entities. Revised §1(h)(10)(C)(iv) defined a partnership as a pass-thru entity for this purpose.

Thereafter, the IRS Restructuring and Reform Act of 1998[10] amended §1(h); the amending provisions renumbered the various subparagraphs of subsection 1(h). Following such amendment, the basic rules pertaining to unrecaptured §1250 gain were contained in §1(h)(7) and the direction to promulgate regulations was contained in §1(h)(12).

The provisions pertaining to unrecaptured §1250 gain were again renumbered without substantive change in 2003. JGTRRA renumbered former §1(h)(7) (the basic definition of unrecaptured §1250 gain) back to §1(h)(6) and former §1(h)(12) (the direction to the Treasury Department to promulgate regulations regarding pass-thru entities) back to §1(h)(10).

These former provisions are largely of historical significance only, although one should note that the implementing regulations[11] do reference the pre-2003 numbering for the 25% rate (i.e., §1(h)(7)) rather than present law numbering (§1(h)(6)). For convenience, because the section has been renumbered so often in the seven years since enactment, we try to avoid referencing the Code directly and instead refer where possible to the concept itself (e.g., the "25% rate").

The Way the 25% Rate Presently Works

Present law §1(h)(6) works by imposing a 25% maximum tax rate on the capital gains attributable to "unrecaptured §1250 gain." The reference to §1250 is obvious: it implicates depreciation on real property. The reference to "unrecaptured" is likewise obvious, even though it operates in the form of a negative definition. Section 1250 will normally work to convert (i.e., "recapture") an amount of the gain that is realized when depreciable real property is sold from capital gains into ordinary income.[12] The amount recaptured by §1250 is normally the amount by which the depreciation exceeds the depreciation that would have resulted under a straight-line method. Thus, the reference within present law §1(h)(6) to an "unrecaptured" amount is a reference to the remaining depreciation after application of §1250 to sale gain. "[G]ain" is the amount by which the sales price exceeds the tax basis.

Avoiding ensnarement by §1250 has long been a goal of savvy tax planners. One way to avoid the reach of §1250 was to limit the real property depreciation to straight line, since there is then no excess of depreciation over that permitted by the straight-line method.[13] Even where the client was predisposed to claim accelerated depreciation for his or her real property prior to TRA '97, the application of §1250 to sale gain was not cataclysmic. This is because the amount of gain attributable to straight-line depreciation was still taxable at long term capital gains rates, as was any gain exceeding the amount of depreciation.

The changes to §1(h) made by TRA '97 change this tax regime in a significant way. For most taxpayers §1(h) imposes a 25% tax on the depreciation that is not recaptured by §1250. Mechanically, this is accomplished by defining as the "unrecaptured §1250 gain" (i.e., the amount subject to the 25% tax) an amount of capital gains equal to the depreciation that would be subject to §1250 if §1250 applied to all depreciation (rather than just to the amount in excess of straight line).

[10] P.L. 105-206, §6007(f)(1).

[11] Regs. §1.1(h)-1.

[12] As noted below, there may be another implication to use of "unrecaptured," which is to limit the amount of partnership level gain to which the 25% rate applies when a partner has previously been subjected to the 25% rate relative to that partnership's property at the *partner* level.

[13] Straight-line depreciation of real estate has been mandatory since the mid-1980's, and so the reach of §1250 recapture even pre-TRA '97 was primarily limited to older properties.

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Application of §1(h) when the taxpayer owns real property directly (i.e., not through a partnership) is simple as follows:

Example 1. Taxpayer X owns Black Acre, with a depreciated basis of $40 that she sells for its fair market value of $100 in a fully taxable transaction after she has held in 5 years. X is taxable at the highest marginal rates. Depreciation of $45 has been claimed, of which $35 would be the straight-line amount, and $10 would be the accelerated component. Prior to TRA '97, of the $60 gain would be taxable, $10 would be taxable under §1250 as ordinary income, and $50 would be taxable as long term capital gain.

Example 2. Assume the same facts as in Example 1, except that the sale occurs after the effective date of TRA '97. Of the $60 gain the first $10 would be taxable under §1250 as ordinary income. The next $35 (the amount equal to the remaining depreciation) would be taxable as "unrecaptured §1250 gain," i.e., at a 25% capital gains rate, and the remaining $15 of gain would be taxable as long term capital gain.

Does §1(h) Automatically Apply to Partnership Property?

It is not clear whether §1(h) automatically applies to property held by a partnership or to dispositions of a partner's interest. Stated differently, if a partnership sells depreciated real property at a gain after the effective date of TRA '97, does the 25% maximum rate apply to each partner's distributive share of that gain? And, if a partner in a partnership holding depreciated property sells her interest does the 25% rate?

The language of §1(h) itself indicates the answer is "no." At all times since its first enactment by TRA '97, the 25% rule has been accompanied by a companion provision provides authority for the Secretary of the Treasury to enact regulations to "apply" §1(h) to "pass-thru entities." The TRA '97 version of this promulgation authority (which remains substantially unchanged in present day §1(h)(9)) is as follows, "The Secretary may prescribe such regulations as are appropriate (including regulations requiring reporting) to *apply* this subsection in the case of sales and exchanges by pass-thru entities and of interests in such entities." (Emphasis added).

"[T]his subsection," of course, is a reference to the entirety of subsection 1(h), and therefore encompasses the 25% rate TRA '97 established through the addition of §1(h)(7). The use of the infinitive verb "to apply" indicates that prescription of such regulations is a necessary precondition to bring partnership property and interests in partnerships within the ambit of §1(h)(7). The Code itself has no other provisions from which the specific application of §1(h) to pass-thru entities could easily be divined. Since the language of §1(h)(11) is reasonably clear in its delegation of power to the Treasury Department, and absent an exercise of the delegated power, one would normally expect the courts to be circumspect in wandering into this quasi-legislative thicket.

Rarely is anything as simple as one would expect, and a contrary view exists that §1(h)(7) was self actuating and applied to partnerships immediately upon TRA '97's enactment. In the Blue Book for 1997 Tax Legislation,[14] the staff of the Joint Committee on Taxation (JCT Staff) indicates that:

> In the case of a disposition of a partnership interest held for more than [12][15] months, the amount of long term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income under §751(a) if §1250 applied to all depreciation, will be taken into account in computing unrecaptured §1250 gain.

This Blue Book statement is made without the benefit of any statutory citation, and of course, there were no implementing regulations in existence[16] at the time the 1997 Blue Book was written.[17] While there are various ways to read this footnote, the opening phrase strongly suggests is that the 25% rate supposedly began to apply upon TRA '97's enactment to all dispositions of partnership interests. "[D]isposition" is a broad term, and seeming encompasses situations where a partner's interest is acquired by the partnership. If so, the clear implication is that the JCT Staff thinks[18] §1(h) applies to all dispositions of a partner's interest whether or not the Treasury Department ever adopts implementing regulations.

Now, the Treasury Department has adopted regulations under the authority granted by former §1(h)(11), presently §1(h)(9). Specifically, T.D. 8902[19] adopted Regs. §1.1(h)-1, effective for "transfers of interests in partnerships, S corporations, and trusts that occur on

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[14] Joint Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97) (Dec. 17, 1997), at 50 n.76.

[15] The actual reference within the Blue Book was to 18 months, which was the holding period applicable at the time of TRA '97.

[16] Regs. §1.1(h)-1(b) was not adopted until Sept. 2000.

[17] The Blue Book was written in Dec. 1997.

[18] A similar reference is contained in the legislative history of the IRS Restructuring and Reform Act of 1998, P.L. 105-206, perhaps suggesting that the JCT Staff wanted to buttress the assertion it had tried to make in the 1997 Blue Book.

[19] 65 Fed. Reg. 57092 (9/21/00).

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or after September 21, 2000. Regs. §1.1(h)-1(b)(3) deals with unrecaptured §1250 gain and provides as follows:

> (3) *Section 1250 capital gain* -(i) *Definition.* For purposes of this section, *§1250 capital gain* means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if §1250(b)(1) included all depreciation and the applicable percentage under §1250(a) were 100 percent.
>
> (ii) *Share of §1250 capital gain allocable to interest in partnership.* When an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under §1(h)(7)(A)(i) in determining the partner's unrecaptured §1250 gain the amount of §1250 capital gain that would be allocated (taking into account any remedial allocation under §1.704-3(d)) to that partner (to the extent attributable to the portion of the partnership interest transferred that was held for more than one year) if the partnership transferred all of its §1250 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of the interest in the partnership. If less than all of the realized gain is recognized upon the sale or exchange of an interest in a partnership, the same methodology shall apply to determine the §1250 capital gain recognized by the transferor, except that the partnership shall be treated as transferring only a proportionate amount of each §1250 property determined as a fraction that is the amount of gain recognized in the sale or exchange over the amount of gain realized in the sale or exchange. *This paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest.* (emphasis added).

The highlighted language within the regulation is not coincidental. This language was not in the initial version of the proposed regulations, and the preamble to the final regulations is clear that the last sentence was deliberately added in response to practitioner comments, as follows:

> d. Redemption of a Partnership Interest
>
> Some practitioners have expressed concern that the look-through capital gains provisions of the proposed regulations apply to the redemption of a partnership interest. To apply the regulations in the context of redemptions, it would be necessary to import the concepts utilized in §751(b). Treasury and the IRS believe that this would not be advisable. Accordingly, these regulations do not apply to any transaction that is treated as a redemption of a partnership interest for Federal income tax purposes.

Section 751(b) generally supplants the normal partnership distribution rules in determining taxation to a receiving partner, and substitutes a rule whereby the distribution is characterized by reference to the partnership's assets. The concern expressed by the IRS in the preamble is understandable, since TRA '97 not only had added the concept of unrecaptured §1250 gain in §1(h), but had also amended §751 without then mentioning unrecaptured §1250 gain. Prior to its amendment by TRA '97, §751(a) provided a general rule that upon the sale or exchange of a partner's interest, amounts attributable to "substantially appreciated inventory" or "unrealized receivables" as defined in the statute (so called "hot assets") were subject to ordinary income treatment. Amounts that §1250 would convert from capital gain to ordinary income (i.e., real property depreciation in excess of straight-line) were included as "unrealized receivables" for purposes of §751 by §751(c). Pre-TRA '97 §751(b) provided that a distribution in which a partner received hot assets in exchange for its interest in certain other partnership property or received certain other property in exchange for the partner's interest in hot assets was to be treated as a taxable sale or exchange of non capital asset property (i.e., subject to §751(a)) rather than as a nontaxable distribution. As relevant here, then, pre TRA '97 §751(b) overrode the normal partnership distribution rules and flowed partnership level tax characterization out to the partner that receives a given partnership distribution.

As noted above, prior to TRA '97, inventory had to be "substantially appreciated" to become a hot asset. TRA '97 deleted this requirement for §751(a) purposes, so that subsequent to TRA '97, any amount of inventory of would give rise to recharacterization in the context of a sale of partner's interest. TRA '97, however, left intact the requirement that inventory had to be substantially appreciated before §751(b) would recharacterize a distribution.

Two related points emerge from TRA '97 amendment of §751(b) that may well have concerned the IRS sufficiently to result in the addition of the last sentence of Regs. §1.1(h)-1(b)(3). First, since §1250 recapture amounts were already defined as an "unrealized receivable" for §751(b) purposes, Congress could have cross referenced "unrecaptured §1250 gain" into §751 at the same time that it deleted the

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"substantially appreciated" requirement for §751(a) purposes if Congressional intent really was as the JCT Staff suggested, i.e., to have partnership distributions recharacterized by reference to partnership level characteristics. Second, by not deleting the requirement that inventory be substantially appreciated before the distribution recharacterization rules of §751(b) would operate, Congress was indicating that there was something different when a partnership interest is being sold to others rather than being extinguished through distributions by the partnership.

It may also be that the IRS just took a narrow view of the Blue Book language — which is that the 25% rate is to apply to dispositions of partner interests that are directly subject to §751*(a)*, i.e., sales of partner interests. Since neither the Code nor the Blue Book mentions §751*(b)* distributions, perhaps the IRS simply was unwilling to promulgate a regulation that extended the Code into an area where Congress had not made such an intent clear. If this approach is correct, it perhaps places Regs. §1.1(h)-1(b)(3) within the realm of an implementing regulation rather than a legislative one. Time will tell how the courts regard it.

Whatever may ultimately underlie the last sentence of Regs. §1.1(h)-1(b)(3), ultimately, the IRS is the agency to apply the 25% rate. Thus, the fact that the IRS does not think the regulations implementing the 25% rate apply to partnership redemptions is controlling from a practical perspective, despite what the JCT Staff may think. This means, we think, that a "partnership redemption" provides an avenue by which one can avoid characterization of regular long term gain as unrecaptured §1250 gain.

The task becomes to identify what is a "partnership redemption."

What Exactly Is a Partnership Redemption?

The partnership provisions of Subchapter K of the income tax provisions of the Code do not contain the phrase "partnership redemption." Corporate practitioners, of course, know immediately what a redemption is in the corporation context: it is a transaction whereby a corporation repurchases and extinguishes the equity interest represented by certain of its outstanding shares. Subchapter K, of course, does contain a number of provisions that address similar types of situations concerning a partnership.

At the outset, we note that there can be (and often is) a threshold problem of characterization when a partner's interest in extinguished for cash. One possibility is that the transaction will be treated as a sale by the departing partner to the remaining partners, which would normally produce capital gain to the departing partner, and an outside basis step up to the purchasing partners. The internal capital accounts of the partnership are not reduced under this treatment; instead, the capital attributable to the departing partner is transferred to the purchasing partners. The other possibility is that the transaction will be treated as a liquidation[20] of that partner's interest. Under this approach, the partnership is the purchaser, not the remaining partners, and there is accordingly no step up in outside basis. And, the partnership's capital contracts to reflect the payment to the departing partner.

With this in mind, the author thinks the best way to interpret the reference within the §1(h) regulations to a "partnership redemption" is to equate the phrase with what Subchapter K would call a "liquidation". That is, a partnership redemption has occurred when the partnership (and not fellow partners) extinguishes (or "liquidates") the interest of a partner through a payment or conveyance in kind to that partner.

Examples

For a partnership with unrecaptured §1250 gain, in view of the last sentence of Regs. §1.1(h)-1(b)(3), the general effect of redemption treatment is to transfer the economic cost of the 25% rate to the remaining partners, while treatment other than as a redemption leaves the economic consequences with the departing partner (i.e., the one who claimed a share of the depreciation in the first place). The below examples include illustrations concerning a hypothetical §754 election[21] by the partnership.

> ***Example 3:*** Partnership MBJ has three equal partners, who each contributed $100. MBJ sole asset is a single property of depreciable real estate, which was purchased several years ago for $300 cash, and which has been depreciated to a basis of $210. If MBJ sells the real estate for its original purchase price of $300, MBJ will realize $90 of long term capital gain. By the express terms of present law §1(h)(6), all of this $90 is unrecaptured §1250 gain, which is allocable $30 to each partner. Thus assuming each partner is otherwise subject to tax at the maximum capital gains rates,

[20] In general, §736 divides cash payments for the liquidation of a partner's interest into two general groupings: (1) "§736(b) payments," which are treated as distributions subject to the provisions of §§731, 732, 734, 737 and 751(b); and (2) "§736(a) payments," which are treated as distributive shares of partnership income under §702 to the extent governed by that income, or as guaranteed payments under §707(c) if not so governed.

[21] An election under §754 permits a partnership to adjust its basis in its property (so-called "inside basis") to reflect gain recognized by a distributee partner as described in §734 or to reflect the adjusted basis of a transferee of a partner's interest as described in section §743.

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each partner will bear a $7.50 tax (i.e., the 25% tax rate) applicable on his or her share of gain. Each partner's outside basis is stepped back to $100 by virtue of the distributive share of gain, and assuming the $300 proceeds are distributed in the sale year, the partners will have no further tax consequences whether or not a §754 election is in effect.

Example 4: Assume the same facts as in Example 3, except that Partner B sells his interest for $100 equally to Partners M and J (each paying $50 to B), immediately prior to a sale of property for $300 by the partnership to a third party. Partner B will recognize $30 of long term capital gain, again characterized as to him as unrecaptured §1250 gain. Presumably, this will leave the partnership with $60 of unrecaptured §1250 gain. Assuming there is no §754 election in effect, MBJ's inside basis remains at $210, so $90 of gain is produced on sale. Of the $45 in sale gain allocable to each of M and J, $30 is unrecaptured §1250 gain. The gain allocation increases the basis of each of M and J to $ 165 ($70+$50+$45). If the partnership is liquidated during the sale year by distribution of the $300 in sales proceeds, M and J will recognize a loss on the liquidation of $15 ($150 proceeds minus $165 basis), so that there net capital gain for the year of $ 30 ($45 gain less $15 loss), all of which is unrecaptured §1250 gain.[22]

Example 5: Assume the same facts as in Example 4, except that a §754 election is in effect. Upon the purchase of B's interest, the partnership basis steps up to $240 ($210+$30). The partnership recognizes a $60 gain from the sale of the property, all of which is unrecaptured §1250 gain. Partners M and J step their basis up to $150 ($70+$50+$30) and do not recognize further gain or loss when $150 are distributed to them.

Example 6: Assume the same facts as in Example 4 (including that there is no §754 election is in effect) but that the partnership is liquidated in the year after the sale. M and J will each be allocated $45 of the gain from the sale of the property, $30 of which is unrecaptured §1250 gain. In the year of liquidation, M and J will recognize a $15 loss, which must be used prospectively.

Example 7: Assume the same facts as in Example 4, except that the sale of B's interest is to a third party, S. B still recognizes $30 of unrecaptured §1250 gain. Presumably, the partnership's unrecaptured §1250 gain again is reduced to $60, allocable only to M and J. When the property is sold for $300 and the proceeds equally distributed in liquidation in the year of sale, J, S, and M should each be allocated $30 of the total $90 of gain ($300 less $210 of inside basis if no §754 election). Of the $30 of gain so allocated to each, all of which is unrecaptured §1250 gain to M and J. The $30 of gain allocated to S is all long term capital gain. Distribution of the liquidation proceeds in the same year means S has net no gain or loss ($30 gain less $30 loss ($100 distribution less $130 basis) while M and J each have a $0 loss on liquidation ($100 distribution less $100 outside basis [$70+$30]), and net capital gains for the year of $30.

These examples are not particularly remarkable. Example 3 demonstrates the "base case" tax treatment for unrecaptured §1250 gain, a partnership level sale where each partner then picks up their share of the unrecaptured §1250 gain. Perhaps the greatest leaps of faith are made in Example 4 and Example 7, which is that, when one partner has to recognize unrecaptured §1250 gain, then the total amount of the partnership's unrecaptured §1250 gain goes down accordingly and the remaining amount of unrecaptured §1250 gain flows to the other partners who have benefited by the underlying depreciation. Presumably, however, these concepts are consistent with the use of the term "unrecaptured" within the statutory phrase "unrecaptured §1250 gain." It also would seem to be consistent with the ability of a partnership holding unrecaptured §1250 gain to take account of "remedial allocations" under the §704 regulations.[23] Example 6 illustrates the trap that exists without regard to the presence of unrecaptured §1250 gain for partnerships that sell appreciated property without the protection of a §754 election. Under the facts of Example 6, the presence of unrecaptured §1250 does not increase the gain to be recognized because of the lack of a §754 election.

So long as Examples 4 and 7 are right, the pattern that emerges from Examples 3 through 7 is that when the departing partner recognizes unrecaptured §1250 gain the other partners will not have to bear any added unrecaptured §1250 gain, regardless of whether a §754 election applies.

[22] The result should be essentially the same if B sells his interest for $100 to a third party.

[23] See Regs. §1.1(h)-1(b)(3)(ii), which cross-references remedial allocations under Regs. §1.704-3(d).

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Consider, however, what potentially happens when a partnership redemption occurs, depending on whether a §754 election is in effect when the sales price of the depreciable real estate exceeds the value implicit in the redemption. For the ease of the reader, we restate the salient facts of Example 3 again in Example 8.

Example 8: Partnership MBJ has three equal partners, who each contributed $100. MBJ sole assets is a single property of depreciable real estate, which was purchased several years ago for $300 cash, and which has been depreciated to a basis of $210. MBJ redeems the interest of Partner B for $100 a year prior to a sale of the property for $400 by the partnership to a third party. No §754 election is in effect. The tax consequences are as follows. B should have $30 of gain, and probably none of it is unrecaptured §1250 gain.[24] MBJ will realize $190 of long term capital gain ($400 less $210 basis). By the express terms of §1(h)(6), $90 is unrecaptured §1250 gain, and the balance of $100 of gain is long term capital gain. Partner B, of course, is gone from the partnership, so the entirety of the $90 of unrecaptured §1250 gain as well the $100 of remaining gain is allocable equally to M and J. M and J are clearly bearing the added tax cost for the depreciation enjoyed by B. Assuming the $400 of sales proceeds are distributed in the sale year, M and J will each have net gain for the year of $80.

Example 9: Assume the same facts in Example 8, except that a §754 election is in effect. The tax consequences are as follows. B will still have $30 of gain, and probably, again none of it is unrecaptured §1250 gain. The §754 election means MBJ will realize $160 of long term capital gain ($400 less basis of $240 ($210+$30)). However, the amount of unrecaptured §1250 gain remains at $90, and nothing operates (at least expressly) to make an adjustment for the partnership. Accordingly, the result seems to be that M and J must still each recognize $45 of unrecaptured §1250 gain, with the balance of $70 of gain is long term capital gain. Again, B has been successful in shifting a portion of the tax bill for the depreciation he received to his former partners.

All in all, a good result for B, but a not so good result for M and J. M and J may need better tax counsel.

Drafting Considerations

The foregoing suggests a number of considerations for partners and soon to be former partners in partnerships holding depreciable real estate. The first question, of course, is who will bear the departing partner's share of depreciation. While the instinctive reaction is that the departing partner should bear his or her own consequences, well informed parties will likely bargain on this point. One or more of the parties may have tax considerations (e.g., capital loss carryforwards) that will allow an arbitrage to every one's benefit. There also are the usual time value of money considerations that may make it prudent simply to defer the 25% tax.

Assuming the departing partner's wishes to avoid his or her gain from being characterized as "unrecaptured §1250 gain" it is extremely important to make sure that the relevant agreement is not inconsistent with characterization as a redemption. While the departing partner does not have direct control over the manner in which the partnership maintains its books, or even files its tax return, the agreement can (and should) (1) use language of redemption; (2) make the partnership (and not the remaining partners) the payor of the "redemption" amounts; and (3) require the partnership to treat the transaction as a redemption for purposes of its own tax returns and books and records. To the extent the departing partner has control (and some do not), the buy out check should come from the partnership and not directly from the remaining partners.

The remaining partners will likely want to make sure the departing partner bears his or her share of the unrecaptured §1250 gain, and thus, will likely seek to avoid redemption characterization. Specifically, they will likely try to have themselves (and not the partnership) treated as the payor to the departing partner. Similarly they should avoid any sort of characterization of the transaction as anything other than a purchase and sale. Redemption language should not be used.

A further comment is in order for a party that is buying into a partnership with unrecaptured §1250 gain, as in Example 7. Such a party should insist as a precondition to his or her buy in that the partnership agreement be amended to allocate all unrecaptured §1250 gain to the other partners. While this result may obtain under Regs. §1.1(h)-1(b)(3), why take the chance?

[24] This presumes the argument prevails that is made in the preceding paragraphs of this memorandum, i.e., that the promulgation of regulations specified in former §1(h)(11), presently §1(h)(10), has not occurred as to partnership redemptions by virtue of the last sentence of Regs. §1.1(h)-1(b)(3)(ii), and that absent implementing regulations, that the concept of unrecaptured §1250 gain does not apply.

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In a related vein, one should consider drafting partnership agreements to provide that a separate account within the partnership books and records be created to record unrecaptured §1250 gain, with each partner under an obligation to provide information to the partnership as to the manner in which that partner has reflected unrecaptured §1250 gain on his or her individual tax return. Further, although not clear from the implementing regulations, it may be that a well drafted partnership agreement could provide that a partner being redeemed must still report a portion of his or her gain as unrecaptured §1250 gain despite the exclusion of partnership redemptions from the reach of the present regulations.

SUMMARY

The present statutory and regulatory scheme concerning unrecaptured §1250 gains leaves flexibility for partnership redemptions. Whether this is truly a good thing depends on whether the departing partner and the partnership (i.e., remaining partners) are fully advised as to their options and the tax cost to those options.

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