Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear

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There are two basic ways to exit a partnership: (1) receive a liquidating distribution of cash of property from the partnership or (2) sell or exchange the partnership interest to a third party. For the most part, an all-cash exit will be taxed the same whether cash is received from the partnership or from a third party (although there are some differences, discussed below). Non-cash exits, though, are taxed very differently depending on whether property is received directly from the partnership (generally a tax-free transaction) or from a third party (generally a taxable transaction). For the non-exiting partners, with one important exception the form of the exit largely is a matter of indifference other than the obvious difference that when cash or property is distributed the venture becomes smaller while if the interest is transferred the venture retains its size.

The two basic exit patterns can be combined, and the focus of this article will be on such combinations. That is, the exiting partner will receive cash or property in a non-pro rata but non-liquidating distribution and then, sometime later, will exit the venture via a sale or exchange of the remaining partnership interest. As discussed below, such exit strategies offer significant tax reduction opportunities. As a result, challenges by the government should be anticipated. Accordingly, such possible challenges are anticipated and their merits considered in detail. One possible challenge to each of the exit techniques discussed below is possible application of the step-transaction doctrine. Much has been written on that doctrine, and this is not the place to till such familiar territory despite fertility of the soil. Nevertheless, if the nonliquidating distribution is quickly followed by a sale or exchange of the remaining partnership interest, one easily can imagine that the sale will be recast as part of the prior distribution or that the nonliquidating distribution will be treated as part of the subsequent disposition. While worthy of considerably further comment, my remarks will be brief and limited to the margins.[2]

A. A Quick Summary of the Rules Applicable to Partnership Exits

1. Disposition of a Partnership Interest

If a partnership interest is transferred in exchange for cash or property, the transferor recognizes gain or loss in accordance with the familiar rules in section 1001.[3] The transferee takes a cost basis in the interest so acquired although the transferee's capital

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[2] Most footnotes have been omitted from this preliminary draft.

[3] See section 741.

account is not based on the value of the consideration furnished but rather carries over from the transferor. This includes, in particular, the transferor's share of forward or reverse 704(c) gain in the partnership's assets as of the time of disposition of the partnership interest. There are, of course, exceptions to those rules for tax-free transactions such as contributions to a controlled corporation pursuant to section 351 and contributions to an upper-tier partnership under section 721. However, the transfer of a partnership interest will not qualify for nonrecognition under section 1031 even if received in exchange for another partnership interest or for property which is of like-kind to the assets held by the partnership itself. Further, special rules apply if the disposition collapses the partnership either because one partner sells to the other in a two-person partnership or all of the partners sell to a third party.

The character of the gain recognized by the exiting partner is capital subject to recharacterization under section 751(a). Under section 751(a), the exiting partner recognizes ordinary income or loss equal to the amount of ordinary income or loss that would be allocated to her if all of the partnership's assets had been sold for their fair market values immediately prior to the disposition. Capital gain or loss is recognized in an amount equal to the total gain or loss recognized under section 1001 on disposition of the interest less the amount of ordinary income (or plus the amount of ordinary loss) computer under section 751(a).

For determining the rate of tax on the capital gain portion arising from the disposition of a partnership interest, section 1(h) imposes a look-through to the underlying partnership assets. Thus, depending on the assets held by the partnership, the exiting partner may recognize capital gain taxable at 15, 25, or 28 percent. Note that there cannot be any section 1031 gain arising from the sale or exchange of a partnership interest, and the capital gain will be long-term or short-term depending on the exiting partner's holding period in the partnership interest. Recently promulgated regulations provide that a partner can have multiple holding periods for a single partnership interest, so that a single sale or exchange can in fact produce ordinary income, short-term capital gain, and long term capital gain taxed at 15, 25 and 28 percents. As discussed below, exiting the venture through a distribution rather than a sale or exchange can eliminate the capital gain look-through rule, thereby allowing the exiting partner to recognize all of the capital gain at the lowest, 15 percent rate. This can be an important consideration for many partners especially those exiting real estate ventures in which real property improvements were depreciated prior to the exit.

If the partnership has a section 754 election in effect or files such an election for the partnership's taxable year in which the sale or exchange of the interest occurs, the inside basis of the partnership's assets will be adjusted based upon the value transferred by the incoming (i.e., purchasing) partner. In general, the adjustment will give the incoming partner a fair-market value basis in each of the partnership's assets so that if one or more partnership assets are sold immediately after the incoming partner joins the venture, no gain or loss will be recognized by the incoming partner. As a technical matter, the incoming partner will be allocated gain or loss from such a sale equal to the gain or loss that would have been allocated to the exiting partner had there been no transfer of the partnership interest, and then the inside basis adjustment (technically made under section 743(b) and allocated among the partnership's assets under section 755) offsets

the amount of the gain or loss so allocated. Note that no inside basis adjustment is made unless an election under section 754 is in effect unless, at the time of the disposition of the partnership interest, the excess of the partnership's adjusted basis in its assets is more than $250,000 greater than the fair market value of those assets; in such a case, a downward basis adjustment is made despite the absence of a partnership election under section 754. Such a mandatory downward adjustment, like all optional upward and downward under section 743(b), affects the incoming partner only.

The incoming partner enjoys the section 743(b) basis adjustment, the outgoing partner recognizes gain or loss, but for the continuing partners the transaction has no consequences with one important exception: the sale or exchange or more than 50% or profits and capital in the venture within any 12-month period causes a technical termination of the partnership. Because a distribution (whether liquidating or not) is not treated as a "sale or exchange" of the partnership interest, exiting in exchange for a liquidating distribution will avoid risk of a technical termination. The principal consequence of a technical termination is that the partnership's depreciable property (but not its amortizable section 179 intangibles) is treated as newly placed in service as of the date of the technical termination. Such a depreciation restart can be onerous for many partnerships, especially for those holding long-lived depreciable assets such as improved real estate. Accordingly, this is another reason why exiting via liquidation may be preferable to a sale or exchange of the partnership interest. Further, if the exit is effected through a two-step process consisting of a non-liquidating distribution followed by a sale or exchange of the diminished partnership interest, the risk of a technical termination is reduced because it is only the diminished profit and capital share that will be treated as sold or exchanged.

2. Liquidating Distributions

The tax consequences of exiting via a liquidating distribution vary depending on whether the distribution consists of cash or property. If the distribution consists of cash, then gain or loss is recognized based on a comparison of (a) the amount of cash distributed with (b) the exiting partner's pre-distribution outside basis. This is the same computation that is used to compute gain or loss on the disposition of a partnership interest, and so the amount of gain or loss recognized should be the same.

The character of the gain or loss may be different, however. Ordinary income will be captured by section 751(b), and in contradistinction to section 751(a), section 751(b) applies to partnership inventory only if the inventory is "substantially appreciated." This limitation can permit a small amount of ordinary income to be converted into capital gain, but more importantly (especially in a down economy) it can have the negative consequence of converting what otherwise would be ordinary loss from the disposition of partnership inventory into capital loss.

To the extent that the distributee recognized capital gain on the distribution, the gain will be taxed at the lowest rate because there is no 25% or 28% look-through under section 1(h) applicable to partnership distributions. While there is no obvious reason why the higher capital gain rates can apply to dispositions of partnership interests but not to distributions, that is the way the statute is written. Further, a section 754 election

by the partnership will ensure that capital gain recognized by a distributee will not be recognized a second time by any other partner. Thus, avoidance of the higher rate capital gain is permanent if the partnership has made or makes an election under section 754.

If the liquidating distribution does not include cash in excess of the distributee partner's outside basis, no gain can be recognized even if substantial property is distributed. The one exception, though, is that the distributee partner must pick up her share of the partnership's ordinary income under section 751(b) to the extent that the distribution otherwise would shift some or all of the distributee's share of ordinary income to other partners.

If property rather than cash is distributed, the distributee pushes her outside basis into the distributed assets. Ordinary income assets take a carryover basis, and whatever remains of the distributee's outside basis is allocated among the distributed capital gain and section 1231 assets. If the capital assets enjoy a basis in the hands of the distributee in excess of the partnership's pre-distribution inside basis in those assets, then under section 734(b) the partnership must adjust its remaining inside basis downward by the amount of that excess. Similarly, if the distributed assets take a reduced basis in the hands of the distributee, the partnership enjoys a positive inside basis adjustment in its remaining assets.

The statute specifies that any section 734(b) inside basis adjustment is made to the common basis of the partnership's assets; that is, it is made in favor of all members of the venture. In the context of a liquidating distribution, such a common basis adjustment makes sense: a liquidating distribution is the equivalent of a sale of the partnership interest by one partner to the remaining partners, and in that context the basis adjustment is allocated exclusively to the purchasing partner. In an economic sense, all of the remaining partners are purchasing partners of the distributee's (i.e., exiting partner's) interest in proportion to their shares in the venture. But if the distribution is not in liquidation of a partner's interest, adjusting the common basis of the partnership's property works a basis shift from the distributee partner to the nondistributee partner.

Consider the following example. X and Y each have a 50% interest in the profits and losses of the XY general partnership when XY owns cash of $120 and a capital asset having adjusted basis and book value of $80 and fair market value of $300. Each partner has an outside basis and capital account balance of $100 though the value of each partnership interest equals $210. If the cash of $120 is distributed to X in a nonliquidating distribution, X will report a taxable gain of $20 on the distribution. If the partnership has an election under section 754 in effect for the taxable year, the partnership will adjust the basis of its asset upwards by $20 to $100. Accordingly, if the partnership then sells its assets for its fair market value of $300, there will be $200 of taxable income to the partnership, of which $100 will be allocated to X and $100 will be allocated to Y. At this point, the partnership owns only cash of $300, of which X's share is $90 and Y's share is $210. Note, though, that X has been taxed on $120 and Y has been taxed on only $100. While that is the correct amount in the aggregate (the property had an inside basis of $80 and a value of $300, so that the unrealized appreciated was $220), X has been over-taxed and Y has been under-taxed.

B. Exit Strategies

1. Distribute Appreciated Property to a Low-Bracket Partner

With these rules as background, let us consider three exit strategies. First, consider the following exploitation of rate differential. Exempt organization EO and a group of taxable organizations (collectively called TO) form the ET partnership, with the exempt organization contributing cash of $100 and the same amount of cash collectively contributed by the taxable organizations. The partnership purchases two capital assets, each for $100. Asset #1 increases in value to $200 while assets #2 increases in value to $190. The partnership is ready to sell its assets and would like to minimize the tax liability of the taxable organizations. How can that be done without rearranging the economic shares of the partners?

The partnership should distribute asset #2 to EO in a nonliquidating distribution and then it should sell asset #1. This will produce the following books:

EO		TO		
CA	OB	CA	OB	
$ 100	$ 100	$ 100	$ 100	Formation
45	0	45	0	Book-Up of Asset #2
(190)	(100)	0	0	Distribution of Asset #2
50	50	50	50	Sale of Asset #1
$ 5	$ 50	$ 195	$ 150	Totals

Assets	Book Value	Adjusted Basis	Fair Market Value
Cash	$ 200	$ 200	$ 200

These books show that if the partnership were to liquidate now, it would distribute $5 of its cash to EO and $195 of its cash to TO. That is right: EO has already received asset #2 in-kind, and that asset is worth $190. This value, when added to its $5 share of the available cash, represents its full 50% share of the partnership's $190 value prior to the distribution and sale. Of course, TO's equal share of that value is entirely in the cash.

But notice how the tax consequences have been skewed: each partner included taxable income of $50 when asset #1 was sold. But that is *all* the income that TO will include. Asset #2 is now owned by EO, and when EO sells that asset, there will $90 of taxable income. But that income will be includible entirely to EO – that is, to the organization that pays no tax – even though the economic value of the appreciation in asset #2 was shared with TO.

The taxable organizations have a combined outside basis of only $150 despite having an aggregate share of inside basis of 195, which means that a cash exit by the taxable partners will yield a gain of the $45 previously deferred when asset #2 was distributed to EO. But so long as they remain in the venture, that deferral continues. There is no reason

why the taxable organizations should leave the partnership: while EO remains a partner, its continuing interest in the venture is small (2.5%).

If EO exits the venture in exchange for a cash distribution, there may be adverse tax consequences to the taxable organizations. For example, suppose EO receives a cash distribution of $5 before any additional taxable events have occurred. This liquidating distribution to EO will trigger a negative $45 inside basis adjustment to the partnership if the partnership has a section 754 election in effect (though this adjustment will be deferred if the partnership does not have any capital assets that can absorb the downward basis adjustment). Recall also that a downward inside basis adjustment is mandatory even in the absence of an election under section 754 if the adjustment would exceed $250,000.

2. Distribute Cash to the Exiting Partner Prior to a Sale of the Remaining Interest

Once again, assume that the exiting partner is Y and that the continuing partners collectively are referred to as X. X and Y each contribute $100 to the XY partnership. The partnership purchases a single piece of property for $200, and the value of the property increases over time to $1000. Each partner has a 50% interest in profits and losses of the venture. Y is ready to leave the venture.

Now suppose that Y's exit is accomplished by a nonliquidating distribution followed by a sale of the reduced interest. For example, suppose the partnership borrows $490 on a nonrecourse basis, guaranteed entirely by X. The cash of $490 is then distributed to Y, reducing the value of Y's interest from $500 down to $10. This distribution triggers a gain to Y of $390 under section 731(a)(1) and an equivalent inside basis adjustment to the partnership's common basis under section 734(b). If Y then sells the remainder of its partnership interest to Z for its current fair market value of $10, Y will recognize a gain of $10 on the sale and Z will take a cost basis in the partnership interest of $10. The sale also will trigger an inside basis adjustment in favor of Z equal to the excess of Z's outside basis (that is $10) over Z's share of the partnership's inside basis. Under the section 743 regulations,[4] Z's share of the partnership's inside basis equals Z's share of the previously taxed capital in the partnership plus Z's share of the partnership's liabilities (Z's share of the liabilities equals zero because the liability is allocable only to X). Under these regulations, Z's share of the previously-taxed capital equals the amount of cash Z would received on a liquidating distribution (that is $10), less the amount of taxable gain that Z would be allocated if the partnership sold all of its assets immediately prior to that liquidation (namely one-half of $410, or $205). Accordingly, Z enjoys an inside basis adjustment under section 743(b) of $10 minus ($10 minus $205), or positive $205.

If the partnership then sells its asset, there is a gain of $410 (amount realized of $1,000 less adjusted basis of $590, where adjusted basis equals cost basis of $200 increased by the section 734(b) inside basis adjustment of $390). Half of this gain is allocable to X and half to Z, but Z's share is exactly offset by Z's section 743(b) basis adjustment. Accordingly, the net inclusion is only $205 to X. Thus, *X has deferred recognition of $19*

[4] Reg. §1.743-1(d).

of income5. Putting all this into the books of the venture, we get:

X		Y		
CA	OB	CA	OB	
$ 100	$ 100	$ 100	$ 100	Formation
0	490	0	0	Borrowing
400	0	400	0	Book-up
0	0	(490)	(490)	Distribution[5]
$ 500	$ 590	$ 10	$ 0	Totals

Assets	Book Value	Adjusted Basis	Debt
Property	$ 1000	$ 590[6]	($ 490)

After the sale to Z, we get:

X		Z		
CA	OB	CA	OB	
$ 500	$ 590	$ 10	$ 10	Purchase by Z[7]
0	205	0	205	Sale of Property
0	0	0	(205)	743(b) Adjustment for Z
0	(490)	0	0	Repayment of the Debt
$ 500	$ 305	$ 10	$ 10	Totals

Assets	Book Value	Adjusted Basis	Debt
Cash	$ 1000	$ 1000	

Is this exit strategy too good to be true? I don't think so. Rather, it exploits a well-recognized flaw in Subchapter K, namely that a section 734(b) adjustment is made to the common basis of the partnership's property rather than in the form of a special adjustment in favor of the distributee alone.[8] As a result, a section 734(b) adjustment shifts inside basis from the distributee partner to the nondistributee partners, resulting in income duplication for the distributee and income deferral to the others. But these effects end for any partner on a taxable exit from the venture, so that when the basis shift is followed by the distributee's exit, the income duplication is avoided while the income

[5] This distribution triggers gain to Y of $390 and an equivalent inside basis adjustment under section 734(b)(1)(A) to the partnership's common basis in its asset.

[6] This value equals the partnership's cost of the property ($200) plus the inside basis adjustment under section 734(b) ($390).

[7] The purchase by Z triggers a basis adjustment of $205 in favor of Z under section 743(b)(1).

[8] *See generally* Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 TAX LAW. 343 (2004).

deferral is enjoyed. What makes this work is that (1) income must be triggered to the distributee partner and then (2) the distributee partner must exit before disposition by the partnership of property allocated a positive basis adjustment under section 734(b).

3. Debt-Financed Distribution Followed by Partial Exit

XY borrows $500, pledging its property as security with a guarantee by X and Y. The loan proceeds are distributed to the partners in proportion to their interests in the venture. Y then sells one-half of her interest for its current fair market value ($300) to third-party Z. The books of the venture become:

X		Y		Z		
CA	OB	CA	OB	CA	OB	
$ 0	$ 0	$ 0	$ 0	$ 0	$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
(300)	(300)	(200)	(200)	0	0	Distribution
0	0	(300)	0	300	300	Sale by Y to Z
$ 900	$ 0	$ 300	$ 0	$ 300	$ 300	Ending Values

How is the debt allocated among X, Y and Z?[9] Because of the guarantee by X and Y, the debt is allocated under the recourse debt rules under section 752. Further, because Z has not assumed any personal liability for the debt, Z's share is zero. Assuming that X and Y each remain liable as before, there is no debt shift by reason of the distribution or the sale by Y.[10]

We know that Z, as the purchaser of a portion of Y's interest, must succeed to a portion of Y's capital account. Since the partnership has net equity of $2,000 and, if it were to liquidate, that equity would be distributed $900 to X, $300 to Y, and $300 to Z, we know that Z's capital account must be equal to $300 (and so Y's capital account must be reduced by the same amount). The applicable regulation provides that "the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner." Reg. §1.704-1(b)(2)(iv)(*l*).

On the sale of one-half of the partnership interest by Y to Z, Y's amount realized equals $300 (all from the cash), and so Y's recognized gain also equals $300.[11] Since Z has purchased one-half of Y's partnership interest, it seems as though Z should acquire one-

[9] For the rules governing the allocation of recourse indebtedness, see Reg. §1.752-2.

[10] The debt allocation between X and Y turns on each partner's right of contribution against the other after the creditor enforces payment of the debt. I assume that X has a right of contribution of $200 against Y and that Y has a right of contribution of $300 against X.

[11] Note that Revenue Ruling 84-53 has no relevance to the computation of Y's gain because that ruling speaks only to the computation of the selling partner's adjusted basis properly allocable to the sold partial interest, and here Y's outside basis equals $0.

half of the built-in gain previously allocated to Y under the rule that the capital account of a transferee of a partnership interest must be credited a share of the transferor's 704(c) gain "proportionate to the interest transferred." Reg. §1.704-3(a)(7). On this reading, Z should acquire $400 of the built-in gain in the asset. To be sure, we know that Z's capital account equals only $300, but surprisingly that does not necessarily limit the amount of Z's share of the reverse-704(c) gain. To see this, note that Y's and Z's capital accounts total $600 but their combined share of the reverse-704(c) layer must equal $800 (determined when the partnership's asset was revalued and Y's capital account was restated). Thus, *someone* must have a share of the reverse-704(c) gain in excess of capital account. So what is Z's share of the reverse-704(c) layer?

I believe the best answer is that Z's share of the built-in gain equals only $300 so that Y's share remains equal to $500. As demonstrated below, this answer produces sensible results for both Y and Z. If we treated Z as picking up half of the built-in gain, then the results for both Y and Z make little sense.

Z's purchase of a portion of Y's partnership interest triggers an adjustment under section 743(b). As described in the margin, the amount of this basis adjustment equals the amount of built-in gain that shifts to Z.[12] Thus, the §743(b) adjustment equals either $300 or $400. Consider first the possibility that the §743(b) basis adjustment equals $400. If the partnership sells its asset immediately after Z purchases one-half of Y's interest, we get:

X		Y		Z .		
CA	OB	CA	OB	CA	OB	
$ 900	$ 0	$ 300	$ 0	$ 300	$ 300	Initial values
0	1200	0	400	0	400	Sale of property
0	0	0	0	0	(400)	§743(b) adjustment
0	(300)	0	(200)	0	0	Debt repayment
$ 900	$ 900	$ 300	$ 200	$ 300	$ 300	

If the partnership sells its asset immediately after Z joins the venture, there will be a taxable gain of $2,000, of which 60% (or $1,200) will be allocated to X. The remainder of the taxable gain (namely $800) will be allocated, under the assumption that $400 of the 704(c) gain shifts to Z, equally between Y and Z. If that is true, then Y will include

[12] The amount of the §743(b) basis adjustment equals Z's outside basis of $300 less Z's share's of the partnership's inside basis. Z's share of the inside basis equals Z's share of the partnership's previously-taxed capital plus Z's $0 share of the partnership's liabilities (in this example Z's share of the liabilities is zero). Reg. §1.743-1(d)(1). Z's share of the partnership's previously-taxed capital equals Z's capital account balance of $300 less Z's share of the built-in gain in the partnership's asset; *see id.* Accordingly, Z's share of the previously-taxed capital (and so Z's share of the inside basis) equals negative $100 if Z's share of the built-in gain equals $400 and $0 if Z's share of the built-in gain equals $300. From this, the amount of the adjustment equals $300 less negative $100 (or $400 total) if Z's share of the built-in gain equals $400 while the adjustment equals $300 less zero if Z's share of the built-in gain equals $300. Thus, in either case the §743(b) adjustment equals Z's share of the reverse-704(c) gain.

$400 and Z's $400 gain will be offset by the §743(b) adjustment. Thus, only $1,600 of the taxable gain will in fact be recognized on the sale. That amount, when coupled with the gain of $300 Y reported on the sale, fails to equal the full appreciation in the partnership's asset. Thus, if this analysis is correct, then $100 of unrealized appreciation goes untaxed until Y exits the venture. Such a result is conceivable but is unlikely to be accepted by the government, especially when an alternate analysis exists which eliminates this deferral.

Before moving on to the alternate approach, reconsider this analysis from the perspective of Z. If the property is sold by the partnership immediately after Z joins the venture, Z’s $400 share of the built-in gain is offset by the §743(b) adjustment, a reasonable result. But suppose that the property is *not* immediately sold by the partnership, and suppose further that the partnership’s property is an amortizable §197 intangible so that Z is able to amortize his positive basis in the partnership’s property.[13]

We know that the rationale underpinning the section 743(b) basis adjustment is that the purchasing partner should take a cost basis in each of the partnership’s assets.[14] Since Z paid $300 to Y and Z’s share of the liability is assumed to equal $0, it seems clear that Z’s cost basis in the partnership’s asset should equal exactly $300. Yet, if we assume that $400 of the built-in gain shifts to Z, then Z’s share of the inside basis becomes $400. This is another nonsensical result following from the assumption that half (i.e., $400) of the built-in gain shifts to Z.

But now assume that Z’s share of the built-in gain equals only the amount of gain recognized by Y on the sale to Z; that is, Z’s share of the built-in gain equals only $300. This reduces the §743(b) adjustment down to $300.[15] If the property is sold by the partnership immediately after Z joins the venture, the books become:

X		Y		Z	.	
CA	OB	CA	OB	CA	OB	
$ 900	$ 0	$ 300	$ 0	$ 300	$ 300	Initial values
0	1200	0	500	0	300	Sale of property
0	0	0	0	0	(300)	§743(b) adjustment
0	(300)	0	(200)	0	0	Debt repayment

[13] See Reg. §1.197-2(g)(3).

[14] The amount of the adjustment under section 743(b) is defined to equal the difference between the purchasing partner’s outside basis and the purchasing partner’s share of the inside basis, and amount that will give the purchasing partner a cost basis in the partnership’s assets.

[15] The inside basis adjustment under §743(b) equals Z's outside basis of $300 less Z's share's of the partnership's inside basis. Z's share of the inside basis equals Z's share of the partnership's previously-taxed plus Z's $0 share of the partnership's liabilities. Z's share of the partnership's previously-taxed capital equals $300 less Z's share of the built-in gain in the partnership's asset, now assumed to equal $300. Accordingly, Z's share of the previously-taxed capital (and so Z's share of the inside basis) equals negative $0. From this, the amount of the adjustment equals $300 less $0, or $300.

$ 900	$ 900	$ 300	$ 300	$ 300	$ 300

This analysis does not offer any inappropriate deferral to Y. Similarly, if the asset is not immediately sold but offers amortization to Z, Z's amortizable inside basis now equals $300, precisely what Z paid for the partnership interest. Thus, regardless of what happens after Z buys in, giving Z only a $300 share of the built-in gain (and so leaving $500 with Y) makes sense. Can this result be squared with the language of the regulation which provides: "If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss *proportionate to the interest transferred* must be allocated to the transferee partner." Reg. §1.704-3(a)(7) (emphasis added).

I think it can. When Z purchased a portion of Y's partnership interest, Z paid $300. While the net value of the interest held by Y immediately prior to that sale was $600, the gross value of that interest was $800: its value was reduced to $600 when Y received the debt-financed distribution of $200. If we interpret the "proportionate" language quoted above as referring to the *gross value* of the partnership interest rather than to its debt-reduced net value, we get the better analysis described above. Note further that this result ensures that the only gain that shifts to Z is that gain recognized on the sale to Y. Thus, I conclude that this exit strategy is too good to be true.