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Checklist for Non-Cash Property Distributions from a Partnership

Should an owner conduct business in an entity taxed as a partnership or a corporation is a frequently asked question. In most circumstances, the owner chooses to operate in an entity taxed as a partnership. One of the important reasons for that choice is, in general, distributions of non-cash property can be made by a partnership to partners in a tax-free manner. There is no analog in Subchapter K, which sets forth the tax rules applicable to partnerships, to Section 311 of the Code. Under that provision, when a corporation distributes to a shareholder property with a fair market value in excess of the property's adjusted basis in the hands of the corporation, the corporation recognizes as if it had sold the property to its shareholder. It is often the case that the shareholder, as well as the corporation, will recognize income on the distribution. Partnership distributions of non-cash property typically result in no tax; corporate distributions of non-cash property typically result in a double tax.

Despite the favorable general rules applicable to the distribution of non-cash property by a partnership to a partner, there are five circumstances in which a distribution of non-cash property can trigger gain recognition to a partner or a partnership. The checklist that follows sets forth those circumstances.

Checklist Item 1 – Hot Assets

In broad terms, property held by a partnership can produce capital gain or loss when sold, or it can produce ordinary income or loss. Property that results in ordinary income or loss is categorized as an "unrealized receivable" or as an "inventory item." Unrealized receivables include not only cash basis accounts receivable, but also the partner's share of depreciation recapture under Section 1245 of the Code, along with certain other recapture items. Inventory items include both items commonly recognized as inventory along with other items that would not be treated as a capital asset or as Section 1231 property if sold. Collectively,

unrealized receivables and inventory items are known as “hot assets.”

The partnership rules generally require that a partner have the same percentage share of gain or loss from the sale of hot assets as from the sale of assets that are not hot assets. If a distribution of non-cash property to a partner would cause a partner’s share of income and loss from assets that produce capital gain and loss to differ from the partner’s share of income and loss from hot assets, then Section 751(b) of the Code applies. The rules of the section are complicated, but the general effect is to cause a distribution of non-cash property that changes the percentage share that a partner has in capital gain or loss property compared with hot assets to result in the partnership and the partner recognizing gain on the distribution. The income recognition by the partner and the partnership is designed to assure that the distribution does not distort the amount of capital gain or loss or ordinary income or loss that the partner receiving the distribution has to recognize.

So, check the hot asset rules prior to having a partnership make a non-cash distribution to a partner.

Checklist Item 2 – Disguised Sales

Section 707(a)(2)(B) of the Code deals with circumstances commonly referred to as a “disguised sale.” Under the typical application of the rule, if a partner contributes property to a partnership then receives a distribution of cash or other consideration from the partnership, the transactions can be collapsed such that the partner and partnership are treated as having engaged in a purchase and sale of property. The Regulations under Section 707 of the Code establish a rebuttable presumption that a contribution of property by a partner and a distribution of cash or other non-cash property to a partner within two years of the original contribution can result in the transactions being taxed as a sale of property by the partner to the partnership, not as a tax-free contribution of property and tax-free distribution of cash or other property.

The less widely recognized application of the rule can also occur when a partner makes a cash contribution to a partnership, then, within two years of the contribution the partnership makes a non-cash distribution of property to the partner. The presumption under the Regulations could treat that combination of facts as a purchase of property by the partner from the partnership. The presumption is rebuttable, nevertheless, the partner would have to be prepared to establish that the transaction should be respected as a contribution of cash and a separate distribution of non-cash property.

Partnerships and their partners need to be aware of the possible application of the disguised sale rules when the partnership distributes non-cash property to a partner who had made a cash contribution to the partnership within the prior two years.

Checklist Item 3 – Sections 704(c) and 737

Sections 704(c) and Section 737 of the Code operate in tandem to prevent disguised exchanges of property between partners. In general, under Section 704(c) of the Code, when a partner contributes property with a value that differs from its tax basis, the contributing partner will be allocated any unrealized gain or loss associated with the property when the property is sold.

Section 704 extends its reach in the circumstance in which property with built-in gain is contributed by a partner and the same property is distributed to another partner within seven years of the initial contribution. The partner who contributed the Section 704(c) property is required to recognize gain equal to the lesser of the remaining of Section 704(c) gain that would be allocable to the partner if the property had been sold or the excess of the fair market value of the property over its tax basis.

Under Section 737 of the Code, if a partner contributes non-cash property to a partnership that has a value in excess of his basis, then receives a distribution of other property (not contributed by the distributee partner) within seven years, the partner will have to recognize gain equal to the lesser of the remaining Section 704(c) gain and the excess of the fair market value of the distributed property over the adjusted basis of the distributee partner's

partnership interest.

Beware of the seven-year lookback requirements when a partnership distributes Section 704(c) property or a partnership distributes non-cash property to a partner who had contributed Section 704(c) property within seven years of the distribution.

Checklist Item 4 – Section 731(c)

A fourth exception to the general rule that a distribution of non-cash property by a partnership to a partner is tax-free is found under Section 731(c) of the Code. That section treats the distribution of “marketable securities” as money in an amount equal to the fair market value of the securities. The term “marketable securities” refers to financial instruments and foreign currencies that are actively traded. A distribution of closely held shares of stock would not constitute marketable securities. Shares that are traded on an established financial market would. To the extent the fair market value of the marketable securities exceeds the basis of the partner’s partnership interest, the partner will recognize gain. There are exceptions to the marketable securities rule. For instance, Section 731(c) does not apply to the extent a partner receives the partner’s share of the net appreciation in marketable securities.

Be careful when distributing marketable securities.

Checklist Item 5 – Section 752

Even though a distribution of non-cash property by a partnership to a partner may itself be nontaxable, the distribution may cause the partner to recognize gain if the distribution results in the distributee partner’s share of profits or losses of the partnership being reduced. Under Section 752 of the Code, a partner’s share of liabilities in the partnership is determined, in many cases, with reference to a partner’s share of partnership profits or losses. Under Section 752(b) of the Code, a reduction in a partner’s share of liabilities of in the partnership is treated as a distribution of money by the partnership to the partner. If the deemed distribution exceeds a partner’s basis in the partner’s partnership interest, the partner will recognize gain.

Check the deemed distribution rules of Section 752 when distributing non-cash property.

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To recap, entities taxed as a partnership generally offer the benefit of allowing non-cash property distributions to avoid gain recognition by the partnership and the partner. The same rule does not apply to distributions of non-cash property by a corporation to a shareholder.

As set forth above, however, there are exceptions to the rule. The checklist to apply to determine if a partnership's distribution of non-cash property to a partner can trigger gain recognition to the partner or the partnership includes a review of:

- Section 751(b) – hot asset rule;
- Section 707(a)(2)(B) – disguised sale rule;
- Sections 704(c) and Section 737 – built-in gain property;
- Section 731(c) – marketable securities; and
- Section 752(b) – reduction in liability share.

Do not let the exceptions to the general rule that distributions of non-cash property by a partnership to a partner are tax-free come as a surprise to a partner or the partnership when it comes time to file tax returns.

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