Retiring Partner Distributions

How does a retiring partner is taxed when he or she receives payment for his or her interest from the partnership. In general, a retiring partner who receives a series of liquidating distributions does not recognize gain until the entire basis in the partnership interest is recovered. Similarly, a loss on a series of liquidating distributions is not recognized until the year in which the retiring partner receives the final liquidating payment.

A special choice is available, however, when a retiring partner is to receive a fixed amount of liquidating payments over a period of years. In such a case, the retiring partner may elect to report gain or loss ratably as each liquidating distribution is received. If the election is made, a proportionate share of the partner's basis in the partner's partnership interest is applied against each liquidating payment. The example that follows shows how a retiring partner is taxed both when the election is not made and when it is made.

Example. Jones retires from the ABC partnership. He is to receive a total of $300,000 from the partnership over three years ($90,000 in 1999, $150,000 in 2000 and $60,000 in 2001) in exchange for his interest in partnership property. His basis in his partnership interest is $180,000. Thus, 60 percent of the total ($180,000 divided by $300,000) is a return of basis and 40 percent of the total is capital gain. (Any substantially appreciated inventory would be subject to tax as ordinary income.)

Result. If he does not make the election, he would not recognize any gain in 1999. He would recognize a $60,000 capital gain in 2000 and a $60,000 capital gain in 2001. If he makes the election, he would recognize a capital gain of $36,000 in 1999 (40% of $90,000), $60,000 in 2000 (40% of $150,000), and $24,000 in 2001 (40% of $60,000).

As a general rule, you would not make the election and instead defer recognition of gain as long as possible. By deferring, you achieve what amounts to an interest-free loan from the government in the amount of the deferred tax. However, there are instances when it would be better to accelerate your gain. For example, if you have already realized a loss from another transaction, you might want to make the election so that you could currently make use of the loss to offset the gain.

Also, the normal deferral approach could cause a greater loss as tax breaks are reduced as adjusted gross income reaches a higher level. The election could spread out gain so as to minimize loss of these tax breaks.

What if you are being bought out at a loss? In that case, you may want to make the election to accelerate recognition of your loss so that you can more quickly use it to offset gains from other transactions.

If you have any questions, please do not hesitate to call.