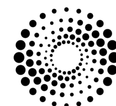
TPST10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

Tax Planning Guide—Partnerships



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Interactive Self-study CPE

Companion to PPC's
Tax Planning Guide—Partnerships

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INTRODUCTION

Companion to *PPC's Tax Planning Guide—Partnerships* consists of three interactive self-study CPE courses. These are companion courses to PPC's *Tax Planning Guide—Partnerships* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **April 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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COMPANION TO PPC'S TAX PLANNING GUIDE—PARTNERSHIPS

COURSE 1

PARTNERSHIP STATUS AND ORGANIZATION (TPSTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an introduction to the decisions necessary to elect and maintain a partnership as a business entity.

PUBLICATION/REVISION DATE: April 2010

RECOMMENDED FOR: Users of *PPC's Tax Planning Guide—Partnerships*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of preparing Form 1065, *U.S. Return of Partnership Income*

CPE CREDIT: 6 QAS Hours, 6 Registry Hours

CTEC CREDIT: 6 CTEC Federal Hours, 0 CTEC California Hours

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FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **April 30, 2011**

KNOWLEDGE LEVEL: Intermediate

LEARNING OBJECTIVES:

Lesson 1—Overview of Partnership Entities

Completion of this lesson will enable you to:
- Recognize common partnership situations and compare partnerships to other business entities.
- Define the check-the-box regulations and the definition of a partnership.
- Recognize Limited Liability Companies and the application of partnership provisions to Limited Liability Companies.
- Differentiate between Limited Liability Companies and Limited Liability Partnerships.
- Identify the partnership anti-abuse regulations and procedures and qualifications for electing out of partnership status.

Lesson 2—Introduction to Accounting Transactions Unique to Partnerships

Completion of this lesson will enable you to:
- Classify, define, and account for organizational costs.
- Classify, define, and account for start-up costs. Recognize amounts required to be capitalized under Code Sec. 263(a).
- Define publicly traded partnerships, utilize joint ventures with tax-exempt entities, and describe series partnerships and Limited Liability Companies.
- Recognize state partnership taxation issues.
- Utilize partnership agreements.

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Lesson 1: Overview of Partnership Entities

INTRODUCTION

Almost every day, practitioners face the task of structuring a new business for a client. This can be one of the most critical decisions the practitioner is involved in—and provides the practitioner with a perfect opportunity to save the client tax dollars and headaches.

To ensure that the client is making the right entity selection, the practitioner needs to be familiar with all aspects of the client's business, know that all major tax and nontax issues have been addressed, and that all possible structures have been considered. Practitioners also need to guard against losing sight of the client's business objectives.

In the past, the choice of entity required a comparative analysis of C corporations, S corporations, partnerships [including general, limited, and limited liability partnerships (LLPs)], sole proprietorships, and limited liability companies (LLCs). With today's sophisticated tax planning, however, many new businesses are structured using two or more of these entities to maximize the advantages offered by each. Even many *one-person* businesses are now structured as limited partnerships with an individual limited partner (the client) and an S corporation general partner with the client as sole shareholder. Entrepreneurial businesses are also frequently structured with multiple entities. Typically, the business is operated in a limited partnership with the investors as limited partners and an S corporation owned by the entrepreneur as the general partner. This partnership structure allows the flexibility to both provide priority allocations to the investors and permit disproportionate capital contributions from the general and limited partners. The limited partners are protected against liability because of their limited partner status and the general partner shareholder also has limited liability when operating as an S corporation.

Whether the new business operates as a single entity or is structured using multiple entities, it is important for the practitioner to understand the tax and nontax advantages and problems of using each type of entity. This course discusses the formation of the partnership entity, how it is different from other entities, partnership variations (e.g., LLCs and LLPs), and partnership agreement drafting considerations.

Choosing to operate a business as a partnership or in some other form, typically a corporation, is affected by a variety of concerns, including rules specifically related to the taxation of partners and partnerships. Nontax concerns, such as limiting liability for business obligations, obtaining public equity financing, or allocating management rights in a particular way, also play a role. Other considerations not directly related to specific partnership tax rules may also have a significant tax impact.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize common partnership situations and compare partnerships to other business entities.
- Define the check-the-box regulations and the definition of a partnership.
- Recognize Limited Liability Companies and the application of partnership provisions to Limited Liability Companies.
- Differentiate between Limited Liability Companies and Limited Liability Partnerships.
- Identify the partnership anti-abuse regulations and procedures and qualifications for electing out of partnership status.

A COMPARISON OF PARTNERSHIPS TO OTHER BUSINESS ENTITIES

When forming a new business, one of the first problems faced by the owner and tax practitioner is choosing the form in which the business will be operated. Should the business be operated as a sole proprietorship, a C corporation, an S corporation, a partnership, or an LLC?

Many factors must be considered when choosing the form of entity for a new business. Based on the owner's goals, one type of entity may be more advantageous than another. Following is a discussion comparing some of the differing characteristics of corporations, partnerships, and proprietorships.

Recognizing Common Partnership Situations

The following are profiles of common situations in which the partnership form can be advantageous:

a. New businesses that expect to incur losses during an initial start-up period can pass through losses to the partners to be deducted on their personal returns.

b. Partners in profitable cash-rich partnerships can receive distributions without being subject to double taxation as shareholders are taxed on corporate dividend distributions.

c. Partnerships can specially allocate items to partners (as long as there is significant economic effect). This option is not available to S corporations since it would in effect create different classes of stock, thus terminating S status.

d. Partnerships have more liberal basis-from-debt rules than S corporations, and they do not face the 100-shareholder limitation or the constraint on types of shareholders that S corporations have.

The following situations lend themselves to shying away from doing business as a partnership:

a. Companies where most of the owners are employees may want to think twice before becoming a partnership, since many common fringe benefits provided to the partners are taxable.

b. Operating in partnership form may make it more difficult to limit the risk of all or most of the owners who actively participate in the business.

c. Operating as an S corporation can limit the owners' exposure to self-employment tax. Partnerships do not have the ability—at least not for general partners.

Certain types of businesses are more likely than others to operate as a partnership. A discussion of why operation as a partnership might appeal to certain types of businesses follows.

Real Estate Limited Partnerships. During the 1970s and '80s, real estate limited partnerships were the tax shelter of choice for many investors. Because the real estate syndication business was (correctly) perceived as a significant arena for tax abuse, Congress devised a series of tax laws to control the problem. Because of these rules, the use of the real estate limited partnership as a tax-sheltered investment is probably a thing of the past. Nevertheless, the joint venture partnership is still the most viable means for structuring most real estate deals involving multiple investors, although the use of limited liability companies (LLCs) has become more common. The partnership form allows investors to pool their funds to acquire or construct large-scale properties that they would be unable to fund or finance on their own, while the flexibility of the partnership form allows the partners to arrange their business dealings so profits, losses, and cash flow are allocated among the partners in almost any manner.

Since partnerships and LLCs can be used to evade taxes, the IRS is shifting more compliance resources to the partnership area, particularly targeting partnerships or LLCs with high-income partners or members. Further, the IRS Schedule K-1 matching program matches information for partners listed on the returns with the information reported on the partners' tax returns. IRS examiners screen returns manually for such items as passive losses, then issue a notice if they cannot determine where the information is reported on the member's return.

Construction Contractors. To share some of the risks associated with the construction industry, contractors commonly form a partnership with one or more other contractors. This allows contractors to increase bonding capacity and working capital while spreading risk over one or more projects. It also has advantages related to human capital, such as combining special talents or expertise in a specialized area of construction, giving the contractor an advantage in bidding, and providing the contractor with local knowledge by joining with a local contractor.

A contractor will have to weigh the advantages and disadvantages of the partnership arrangement before making a decision. He frequently will have to give up some control over the projects he is working on and take on more risk by doing work he is not as familiar with. He also may end up with more liability than he had previously and may have more financial demands, depending on the structure of the arrangement.

Oil and Gas Ventures. Historically, the most common arrangement for oil and gas ventures is co-ownership of the mineral rights in a property (via an oil and gas lease). When co-ownership of mineral rights is combined with a joint operating agreement, the arrangement is classified as a partnership for federal income tax purposes. This classification is only for income tax purposes and, in many instances, does not result in a legal partnership (e.g., joint and several liability) under state law. However, many co-owners do not want their venture to be treated as a partnership for federal income tax purposes. Since oil and gas venture co-owners are considered to be individually involved with the joint production, extraction, or use of property, they can elect to be excluded from the partnership tax provisions (Subchapter K) if the arrangement qualifies as an operating agreement. See further discussion later in this course.

Usually, the most important tax issue for an oil and gas partnership is the current deductibility of intangible drilling costs (IDC). The election to expense IDC is made at the partnership level. Whether the venture is classified as a partnership for both legal and tax purposes or for tax purposes only, the critical impact of such classification is that the partnership (not the partners) must make most tax elections.

Private Equity. Partnerships are becoming increasingly popular for private investment activities. Investors can pool their assets for a greater level of investment and diversification. Partnership rules allow pass-through taxation and creation of ownership interests with varying rights to cash flow, liquidating distributions and tax items. Investment partnerships are covered by special partnership rules. Investment partnerships are also eligible for electing out of partnership rules.

Licensed Professionals. Limited liability partnerships (LLPs) and variations thereof are a relatively new type of general partnership that exists under the laws of many states. They were enacted in response to the concern that a partner of a professional firm can be held liable for the malpractice of another partner in the same firm. In some states, LLP partners and LLC members receive the same liability protection. In other states, LLP partners remain personally liable for the commercial and other obligations of the entity, their own acts and omissions, and for the acts and omissions of persons under their supervision. However, they generally are not liable for acts and omissions by the other LLP partners and nonsupervised employees. Additional coverage of LLPs appears later in this course.

Family Partnerships. A family partnership is a noncorporate entity created by the transfer of property from one or more individuals to the entity for the common economic benefit of family members. In the typical situation, the senior family members (parents) transfer assets to a family partnership in exchange for partnership interests that, under the terms of the partnership agreement, carry with them certain rights. Partnership interests are then gifted or sold by the parents to the children, who cannot sell or transfer their interests, compel distributions, participate in management, or cause the partnership to liquidate. Over time, they can transfer a substantial portion of their wealth to their children in a way that fulfills their tax and nontax objectives.

Limited Liability Companies Taxed as Partnerships. The LLC is an increasingly popular form of conducting all types of businesses because it combines the best attributes of limited partnerships and S corporations. The tax and nontax aspects of this form of business are covered later in this course.

Comparing Partnerships and Corporations

While a C corporation or an S corporation will continue as a legal and a tax entity regardless of the shareholders' status, a partnership terminates under the tax laws (i.e., a technical termination) if a 50% or greater interest in its capital and profits is sold or exchanged within a 12-month period.

The shares in a C corporation or an S corporation usually are freely transferrable. Conversely, a partner in a partnership can usually transfer his interest only with the approval of the other partners (or in the case of a limited partnership, the consent of the general partner). But in many cases, the transfer of stock in a closely held corporation will be similarly limited by the terms of a buy-sell agreement.

The management of a C corporation or an S corporation is centralized in a board of directors and a slate of corporate officers. The corporation's owners have no direct participation in the corporation's management unless they are also employees or directors. On the other hand, a general partnership is usually managed by the partners with no *centralization* of management. A limited partnership more closely resembles a corporation, in that the management of the business is centralized in the hands of the general partners. If limited partners participate in management, they will lose their liability protection.

Forming Partnerships with Various Types of Entities. While a partnership may not be a shareholder in an S corporation, an S corporation is not prohibited from acting as a partner in a partnership. It is common for an S corporation to be the general partner in a limited partnership.

With proper planning, an S corporation can be used advantageously in the partnership area. An S corporation can be a partner in a partnership, and the other partners can be individuals or entities that would be ineligible to be shareholders of the S corporation. An S corporation can also hold an interest in an LLC. S corporations can form partnerships to conduct business activities. Provided each S corporation has fewer than 101 shareholders, the 100-shareholder limit is not exceeded when two or more S corporations combine to operate a single business as a partnership.

Example 1-1: Two or more S corporations can form a partnership without violating the 100-shareholder limit.

Is it viable for a group of 60 unmarried and unrelated individuals to form one S corporation and another group of 60 unmarried and unrelated individuals to form a second S corporation, with the two corporations in turn passing their capital through to form a partnership for the operation of a single business?

Because each S corporation is treated separately, the 100-shareholder limit is not exceeded when two or more S corporations combine to operate a single business as a partnership, as long as each S corporation has less than 101 shareholders.

Benefitting from Limited Liability

A major benefit of doing business in the *corporate form* is the limitation on liabilities of the corporation's owners. Generally, corporate creditors can look only to the corporation's assets for satisfaction of any corporate debts. But as a practical matter, lenders require many shareholders of closely held corporations to personally guarantee corporate debt, so the limited liability advantage of corporations may be more theoretical than real. If a business is operated as a general partnership, however, each of the partners is usually jointly and severally liable for all partnership debts. (This does not apply to any nonrecourse debts.) In a limited partnership, the limited partners are usually not liable for any partnership debts, with all liability for such debts being assumed by the general partners. Limited partners have liability for partnership debt to the extent of capital contributed or capital required to be contributed in the future.

A partner's creditor has limited power to satisfy his claim with a partnership interest of the partner. The creditor can obtain a *charging order* from the courts against the partnership interest. This charging order allows the creditor to receive the distributions that would have been made to the debtor-partner. The creditor has no right to the partnership's assets nor can he have any effect on the partnership's management or operations. Ownership attributes such as the right to vote, the right to sell the partnership interest to satisfy the creditor's claims, and the

right to demand an accounting from the partnership normally are not available to the creditor. In contrast, creditors of a shareholder can obtain full ownership of the shareholder's stock, generally without any restrictions on the ability to vote the shares or sell them. If the charging order does not satisfy the claim within a reasonable time, the creditor can obtain a permanent right to the partnership's distributions, which may exceed the payment of the debt in question.

Partners in a limited liability partnership (LLP) are not liable for debts of the partnership *arising from errors, omissions, negligence, incompetence, or malfeasance* committed in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner, unless that partner was involved in the activity. In a growing number of states, LLP partners also are not personally liable for the firm's contract liabilities, nor are they exposed to vicarious liability. In these states, LLPs offer LLC-like liability protection to their partners. However partners may still be liable for debts they personally guarantee.

Choosing a Tax Year

A partnership is generally required to adopt the tax year of its majority owners. An S corporation, a personal service corporation, and, of course, a sole proprietorship generally are required to adopt a calendar year-end. A C corporation (other than a personal service organization) can adopt any tax year end regardless of whether it coincides with the year end of its principal investors.

Understanding How Passive Loss Rules Apply to the Various Types of Entities

Generally, losses that are generated by passive activities cannot be used by individuals, estates, or trusts to offset active or portfolio income. C corporations, other than personal service corporations and closely held corporations, are not subject to the passive loss rules. A C corporation's passive losses can, therefore, be used without limitation to offset other business income.

Personal service corporations (PSCs) are subject to the same passive loss restrictions as individuals, estates, and trusts. For purposes of the passive loss limitations, a PSC is a corporation substantially owned and operated by employee-owners whose principal activity is the performance of services in the health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting fields.

A closely held corporation can use passive losses to offset active business income, but not portfolio income. Generally, a closely held corporation is one substantially owned by five or fewer individuals.

Passive losses generated by partnerships and S corporations are passed through to the owners, and the passive loss limitations are applied at the owner level. A complex body of regulations govern the application of the passive loss rules, and a great deal of analysis is necessary to apply them correctly.

Comparing Employment Tax Liability

Amounts partners receive for services they provide to the partnership are guaranteed payments (if the amounts are determined without regard to partnership net income). These amounts are basically partner salaries reported on the partner's schedule K-1 rather than Form 1099-MISC. Like Form 1099, they are not subject to any type of payroll tax withholding (i.e., income tax, FICA, FUTA). Guaranteed payments for services are considered self-employment income. Payroll taxes for S corporation shareholders can often be minimized by reducing salary payments and increasing distributions. However, the IRS can recharacterize distributions as salaries subject to payroll taxes if the distributions can be shown to be in lieu of adequate salary. There has been a great deal of activity by the IRS in this area; several cases have recharacterized S corporation distributions as salary.

Accounting for Distributions to Owners

Many distributions to C corporation shareholders are subject to a double tax. The corporation is taxed on the difference between the FMV and basis of the distributed assets as well as on other corporate income. The shareholder is taxed on distributions from the corporation as either dividends or liquidating payments in excess of the tax basis of his shares.

Generally, partnership distributions to partners are not subject to tax unless a cash distribution (including marketable securities treated as cash) exceeds the basis of the partner's interest in the partnership or the distribution is part of a disguised sale transaction. However, distributions of contributed appreciated or depreciated property to noncontributing partners can trigger gain, as can distributions to a partner who contributed appreciated property.

Cash distributions from an S corporation generally are not taxed to the extent the distributions do not exceed the basis of the shareholder's stock plus the amount of loans from the shareholder to the corporation. Distributions of appreciated property from an S corporation are treated as though the property is sold to the shareholder at its FMV—resulting in gain recognition by the corporation. This gain in turn increases the shareholder's stock basis.

Accounting for the Sale of an Interest

The sale of C corporation or S corporation shares produces capital gain or loss. (Loss can be ordinary to the extent of Section 1244 stock.) The sale of a partnership interest generally produces capital gain or loss, unless there is a deemed sale of unrealized receivables or substantially appreciated inventory (i.e., "hot assets").

Understanding State Tax Issues

Generally speaking, every state has a different tax system, but most states tax C corporations on either their income or their capital—and, in some states, corporations are taxed on both. On the other hand, partnerships are rarely subject to state income tax, although their partners usually are subject to state tax on their share of the partnership's income reported on their individual state income tax return. It is important to note that many states do not recognize S corporation status. In these states, S corporations are taxed under the same rules as C corporations, even though, for federal tax purposes, the corporation's income is passed through to the shareholders. Other states require separate S elections under their laws for state pass-through treatment.

Understanding the Formation Process

Although most law firms have a *boilerplate* partnership agreement which is used as the starting point for drafting the documents to form a new partnership, tailoring that agreement to meet the needs of an individual client can be expensive and time-consuming. On the other hand, forming a corporation is a relatively simple process involving filing articles of incorporation and by-laws with a state office. Certain types of corporations and partnerships must also either file registration statements with the SEC or file statements under an exemption from registration. Even though corporations may be easier to form, they are subject to certain ongoing requirements to hold stockholder meetings and keep corporate minutes that do not apply to partnerships.

Analyzing the Cost Related to Formation

Each state has a different fee structure in place which may require corporations and partnerships to pay filing fees upon formation, restructuring, or contribution of additional capital. The practitioner should be aware of these costs and factor them into any analysis of a new business structure.

Converting an Existing C Corporation to an LLC

An existing C corporation can convert to an LLC, which can then elect to be taxed as a partnership. Although this is typically not beneficial due to the high tax cost of the conversion, in the following circumstances, it may be desirable:

a. The corporation holds assets that have not appreciated or that have depreciated. In these situations, the FMV of the distributed property does not exceed the basis of the transferred assets and the corporation does not recognize gain.

b. The corporation and/or the shareholders have NOLs or capital loss carryforwards that absorb any gain recognized on the liquidating distribution.

c. The corporation holds assets that will appreciate rapidly in the future (such as a potential patent, intellectual property, or real estate).

d. The corporation renders professional services and there are no noncompete agreements in effect.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following is a disadvantage to organizing as a partnership?

    a. Losses may be passed through to partners to be deducted on their personal returns

    b. Distributions are not subject to double taxation.

    c. Special allocations of income and loss are allowed.

    d. Fringe benefits provided to partners generally are taxable.

2. Which of the following types of ventures would most likely be organized as a limited partnership?

    a. Real estate venture.

    b. Co-ownership of mineral rights in a property.

    c. Professional service firm.

3. For oil and gas ventures, co-ownership of mineral rights combined with a joint operating agreement could result in which one of the following circumstances?

    a. The arrangement is always classified as a legal partnership under state law.

    b. The arrangement must be treated as a partnership for federal income tax purposes.

    c. Co-owners can elect to be excluded from the partnership tax provisions.

4. LLP partners generally are **not** personally liable under most circumstances for which of the following?

    a. Their own acts and omissions.

    b. Acts and omissions of those they supervise.

    c. Acts and omissions of other LLP partners.

    d. Commercial obligations of the entity.

5. Which of the following statements is most accurate?

    a. C corporations, S corporations, and partnerships continue as a legal and tax entity regardless of the owners' status.

    b. C corporations, S corporations, and partnership interests are freely transferable.

    c. Corporate creditors may look only to the corporation's assets for satisfaction of debt, but general partnership creditors may look to the general partnership's assets and the general partners' assets for satisfaction of debt.

    d. Creditors have a right to demand an accounting of the partnership and a right to demand the sale of a partnership interest.

6. All of the following are subject to the passive activity rules **except**:

   a. C corporations.

   b. Closely held C corporations.

   c. Partnerships.

   d. S corporations

7. The sale of a partnership interest:

   a. Always results in ordinary income or loss.

   b. Always results in capital gain or loss.

   c. May be treated as ordinary or capital gain or loss depending on the types of assets the partnership holds.

   d. Is treated as a distribution due to a deemed sale of assets.

8. Which of the following statements is accurate regarding costs related to formation of corporations and partnerships?

   a. Federal law requires all states to maintain the same fee structure that applies to formation of corporations or partnerships, restructuring, or contributions of additional capital.

   b. Each state has its own fee structure that applies to the formation, restructuring, or contribution of additional capital by corporations and partnerships.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following is a disadvantage to organizing as a partnership? **(Page 4)**

   a. Losses may be passed through to partners to be deducted on their personal returns. [This answer is incorrect. This is an advantage to organizing as a partnership. Partnerships pass losses through to the partners to deduct on their personal returns.]

   b. Distributions are not subject to double taxation. [This answer is incorrect. This is an advantage to organizing as a partnership. Partnership distributions are not subject to double taxation like corporate shareholders are taxed on corporate dividend distributions.]

   c. Special allocations of income and loss are allowed. [This answer is incorrect. This is an advantage to organizing as a partnership. Partnerships may specially allocate income and losses to the partners.]

   d. Fringe benefits provided to partners generally are taxable. [This answer is correct. This is a disadvantage to organizing as a partnership. Many fringe benefits provided to partners who are also employees are taxable according to the Internal Revenue Code.]

2. Which of the following types of ventures would most likely be organized as a limited partnership? **(Pages 4–5)**

   a. Real estate venture. [This answer is correct. Limited partnerships are a common choice of business entity for a real estate joint venture. The partnership form allows investors to pool their funds for large-scale transactions and allows flexible allocation of profits and losses.]

   b. Co-ownership of mineral rights in a property. [This answer is incorrect. Ownership of a mineral rights property is most commonly a co-ownership venture and is not necessarily a partnership. Only when it is combined with a joint operating agreement, will a mineral rights co-ownership venture be treated as a partnership.]

   c. Professional service firm. [This answer is incorrect. Many professional service firms are organized as LLPs.]

3. For oil and gas ventures, co-ownership of mineral rights combined with a joint operating agreement could result in which one of the following circumstances? **(Page 5)**

   a. The arrangement is always classified as a legal partnership under state law. [This answer is incorrect. In many cases, the arrangement does not result in a legal partnership under state law.]

   b. The arrangement must be treated as a partnership for federal income tax purposes. [This answer is incorrect. Although the arrangement is classified as a partnership for federal income tax purposes, it is not an absolute requirement for all co-owners.]

   c. Co-owners can elect to be excluded from the partnership tax provisions. [This answer is correct. Co-owners can elect to be excluded from the partnership tax provisions (Subchapter K) if the arrangement qualifies as an operating agreement. This is because oil and gas venture co-owners are considered to be individually involved with the joint production, extraction, or use of property.]

4. LLP partners generally are **not** personally liable under most circumstances for which of the following? **(Page 5)**

   a. Their own acts and omissions. [This answer is incorrect. Depending on the state they practice in, LLP partners may be personally liable for their own acts and omissions.]

   b. Acts and omissions of those they supervise. [This answer is incorrect. Some states hold LLP partners personally liable for acts and omissions of those they supervise.]

c. Acts and omissions of other LLP partners. [This answer is correct. LLPs are a relatively new type of general partnership that exists under the laws of many states. LLP partners generally are not liable for acts and omissions by the other LLP partners and nonsupervised employees.]

d. Commercial obligations of the entity. [This answer is incorrect. In many states, LLP partners are personally liable for the commercial obligations of the entity.]

5. Which of the following statements is most accurate? **(Page 6)**

a. C corporations, S corporations, and partnerships continue as a legal and tax entity regardless of the owners' status. [This answer is incorrect. Partnerships do not continue if a technical termination, i.e., a 50% change in ownership, has occurred. C corporations and S corporations continue as a legal and tax entity regardless of the owners' status.]

b. C corporations, S corporations, and partnership interests are freely transferable. [This answer is incorrect. Partnerships do not have freely transferable interests. Generally, interests may only be transferred with the approval of the other partners. Shares in a C corporation or S corporation are generally freely transferable unless the entity is a closely held business.]

c. Corporate creditors may look only to the corporation's assets for satisfaction of debt, but general partnership creditors may look to the general partnership's assets and the general partners' assets for satisfaction of debt. [This answer is correct. Generally, corporate creditors may look only to corporate assets to satisfy a creditor's claim. General partners are jointly and severally liable for all partnership debts. Thus, partnership creditors may look to partnership assets or partner assets to satisfy claims.]

d. Creditors have a right to demand an accounting of the partnership and a right to demand the sale of a partnership interest. [This answer is incorrect. Creditors do *not* have the right to demand an accounting of the partnership, a right to demand the sale of a partnership interest to satisfy a debt obligation, or the right to vote.]

6. All of the following are subject to the passive activity rules **except**: **(Page 7)**

a. C corporations. [This answer is correct. C corporations are not subject to the passive activity loss limitations according to the Code.]

b. Closely held C corporations. [This answer is incorrect. Closely held corporations are subject to the passive activity rules per the Code. Closely held corporations are owned by five or fewer individuals.]

c. Partnerships. [This answer is incorrect. Partnerships are subject to the passive activity rules per the Code. Losses flow through to the partners and the passive activity limitations apply to the partners.]

d. S corporations. [This answer is incorrect. S corporations are subject to the passive activity rules per the Code. Losses are passed through to the shareholders and the passive activity rules apply to the owners.]

7. The sale of a partnership interest: **(Page 8)**

   a. Always results in ordinary income or loss. [This answer is incorrect. The sale of a partnership interest generally results in a capital gain or loss unless the partnership has "hot assets."]

   b. Always results in capital gain or loss. [This answer is incorrect. The sale of a partnership interest generally results in a capital gain or loss unless there is a deemed sale of unrealized receivables or substantially appreciated inventory, i.e. "hot assets."]

   c. May be treated as ordinary or capital gain or loss depending on the types of assets the partnership holds. [This answer is correct. The sale of a partnership interest generally results in a capital gain or loss. However, if a deemed sale of unrealized receivables or substantially appreciated inventory, i.e. "hot assets," occurs, the partnership will recognize ordinary gain or loss.]

   d. Is treated as a distribution due to a deemed sale of assets. [This answer is incorrect. The sale of a partnership interest is not treated as a distribution but generally as a sale of a capital asset. The sale of a partnership interest generally results in a capital gain or loss unless there is a deemed sale of unrealized receivables or substantially appreciated inventory, i.e. "hot assets."]

8. Which of the following statements is accurate regarding costs related to formation of corporations and partnerships? **(Page 8)**

   a. Federal law requires all states to maintain the same fee structure that applies to formation of corporations or partnerships, restructuring, or contributions of additional capital. [This answer is incorrect. Federal law does not control the fees that individual states can levy on forming or restructuring corporations and partnerships or on the contribution of additional capital by them.]

   b. Each state has its own fee structure that applies to the formation, restructuring, or contribution of additional capital by corporations and partnerships. [This answer is correct. Different states have different fee structures that require corporations and partnerships to pay filing fees when they are formed, restructured, or when additional capital is contributed.]

UNDERSTANDING THE DEFINITION OF A PARTNERSHIP AND THE CHECK-THE-BOX REGULATIONS

Check-the-box refers to the method that allows eligible entities to choose tax classification using Form 8832 (Entity Classification Election). Before checking the box, it is critical to identify separate entities, as well as to understand the tax distinction between a partnership and a corporation. IRC Sec. 7701(a)(2) defines a *partnership* to include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation. IRC Sec. 7701(a)(3) defines a *corporation* to include associations, joint-stock companies, and insurance companies. A *partnership* is defined under the check-the-box rules as a business entity that is not a corporation [as defined in Reg. 301.7701-2(b)] and has at least two members.

Taxpayers have challenged the IRS claiming the check-the-box regulations are invalid but that claim has been rejected by the 6th Circuit, 2nd Circuit, and Tax Court.

Identifying Entities That Are Eligible to Choose Entity Classification

Under the check-the-box rules, the first step in applying the classification process is to determine if there is a separate entity for federal tax purposes. Certain joint undertakings that are not entities under local law may constitute separate entities for federal tax purposes. A joint venture or other arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the resulting profits. For example, a separate entity exists for federal tax purposes if the co-owners of an apartment building lease space and, in addition, provide services to the occupants either directly or through an agent. A joint undertaking to merely share expenses does not create a separate entity. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented does not constitute a separate entity for federal tax purposes.

The distinguishing factor between joint arrangements treated as separate entities and those that are not is the level of service provided by the owners. The regulations do not provide any specific guidance on what level of service an owner must provide to give rise to a separate entity. It may be important that the term *significant personal services* used in the S corporation passive income regulations and the passive activity regulations is not used in the check-the-box regulations. Since the final regulations do not address the question, practitioners may be able to use this lack of guidance to achieve a particular objective.

Business entities classified as corporations for federal tax purposes include corporations denominated as such under applicable law, as well as associations, joint-stock companies, insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a state, organizations that are taxable as corporations under a provision of the Code other than IRC Sec. 7701(a)(3), and certain organizations formed under the laws of a foreign jurisdiction.

A separate business entity that is not classified as a corporation is an eligible entity and can choose its classification for federal tax purposes. Unless a domestic eligible entity with at least two members elects otherwise, it will be classified as a partnership. The default classification for a foreign eligible entity is that of a partnership if it has at least two members and at least one member does not have limited liability. If all of the members have limited liability, the default classification is that of an association taxable as a corporation.

Classifying Eligible Multi-owner Entities

Business entities that are not required to be treated as corporations can choose their entity status. Eligible entities with more than one owner default to being treated as partnerships for federal income tax purposes. They can also elect to be treated as corporations, which is attractive in only limited circumstances.

Classifying Eligible Single-owner Entities

Eligible single-owner entities, such as the single-member LLC (now permitted in all states), can choose to have their existence ignored for federal income tax purposes. An LLC owned by an individual is treated as a sole proprietor-

ship reporting income on the individual's tax return in the appropriate place (Schedule C, Schedule E, Schedule F, etc.). An LLC owned by another legal entity, such as a corporation, is treated as an unincorporated branch of the parent entity. Alternatively, an eligible single-owner entity can elect to be treated as a corporation in the unlikely event such treatment is more attractive.

Classifying a Qualified Joint Venture Owned by Husband and Wife

Prior to the passage of the Small Business and Work Opportunity Tax Act of 2007 (SBWOTA), it was unclear how to classify a single member LLC owned by one spouse, but operated by both spouses. The only guidance was Rev. Proc. 2002-69, which allowed spouses in a community property state to elect between treatment as a partnership or a sole proprietorship for single-member LLCs. Treatment of such an entity as a partnership could result in additional self-employment (SE) tax if the amount of compensation to the owner spouse for the year exceeded the FICA limit ($106,800 for 2010).

For tax years beginning after 2006, SBWOTA provides that a qualified joint venture conducted by a husband and wife who file a joint return is not treated as a partnership for federal taxes. A qualified joint venture means any joint venture involving the conduct of a trade or business if—

a. the only members of the joint venture are a husband and wife,

b. both spouses materially participate [within the meaning of IRC Sec. 469(h), except for the provision allowing the participation of a spouse to be taken into account] in such trade or business, and

c. both spouses elect not to be treated as a partnership.

If the spouses elect for the joint venture not to be treated as a partnership, all items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture, and each spouse takes into account his or her respective share of the items as if they were attributable to a trade or business conducted by each spouse as a sole proprietor. This relieves the administrative burden of filing a separate partnership return.

Regardless of whether the spousal joint venture is taxed as a partnership, the earnings will be allocated to each spouse based on his or her respective interests for SE tax purposes. This is beneficial because it allows each spouse to receive credit for social security taxes. However, for situations in which the joint venture's earnings exceed the social security wage limit, this may result in the spouses paying additional SE taxes.

Example 1-2: Treatment of spousal joint ventures.

John Dutton is the only member in Cloud Riders, LLC, which operates a retail mattress store. Cloud Riders is treated as a disregarded entity under the default classification rules, and all of the LLC's income and expenses are reported on a Schedule C in John's individual income tax return. The store generates $140,000 of income in 2010, which is all self-employment (SE) income to John. John's wife, Wendy, helps him out at the store and does all of the company's bookkeeping, but does not receive a salary. John and Wendy live in a common law state.

Whether or not John and Wendy make the election out of partnership treatment under IRC Sec. 761(f)(1)(A), John is allocated 100% of Cloud Riders' earnings, because he owns 100% of the LLC. However, it appears that if the IRS determines that, based on Wendy's involvement in Cloud Riders, the LLC should be classified as a 50/50 partnership and allocates the LLC's income equally between John and Wendy, additional SE tax may be due. SE tax would be due on the full $140,000 ($70,000 each allocated to John and Wendy) rather than on a maximum of $106,800 (for 2010) of the $140,000 SE income previously allocated to John.

The Committee Reports on IRC Sec. 761(f)(1)(A) state that "The provision is not intended to change the determination under present law of whether an entity is a partnership for federal tax purposes (without regard to the election provided by the provision)." Consequently, it appears that the IRS still has the ability to recharacterize the joint venture in this example as a partnership.

If John and Wendy live in a community property state, Cloud Riders' earnings are allocated 50/50 even if John and Wendy elect under IRC Sec. 761(f)(1)(A) not to be treated as a partnership. See the discussion of community property states in the following paragraph.

Spousal qualified joint ventures in community property states are subject to the same rules that apply to such joint ventures in common law states. However, since any joint venture that is community property is considered to be owned 50/50 by each spouse, the earnings of the joint venture will be allocated 50/50 between the husband and wife. Income from a joint venture that is separate property would presumably be allocated to the owner spouse if the husband and wife elect not to be treated as a partnership.

The Chief Counsel's Office has clarified that a husband and wife's election of qualified joint venture status for a rental real estate business does not convert the income derived from the business into net earnings from self-employment, when the income otherwise would be excluded from SE tax under IRC Sec. 1402(a) (CCA 200816030).

Recognizing the Special Rules for Exempt Organizations and REITs

Under the default rules of the regulations, an exempt organization under IRC Sec. 501(a) is classified as if the organization made an election to be classified as a corporation. The election is considered to be in effect from the date tax-exempt status is claimed (or determined to apply) until the exemption is withdrawn, rejected, or revoked. At such time, the organization may elect to be classified as an entity other than a corporation under the general rules.

The regulations provide that an eligible entity that files an election under IRC Sec. 856(c)(1) to be treated as a REIT is deemed to have made an election to be classified as an association taxable as a corporation. This deemed election is effective as of the first day the entity is treated as a REIT.

Understanding the Effect of Partnership Terminations and Divisions

If an existing domestic eligible entity that is treated as a partnership terminates under IRC Sec. 708(b) due to changes in ownership, or is involved in a transaction in which the partnership divides into two or more partnerships, the new entity (or entities) is automatically classified as a partnership.

Example 1-3: The effect of a technical termination on the tax classification of an LLC treated as a partnership.

Casey and Carlton each own 50% of All-Star Sporting Goods (ASSG), which is an LLC taxed as a partnership. On January 1, Casey and Carlton each sell 30% (for a total of 60%) of their LLC interests to Paige. ASSG has terminated for tax purposes (a technical termination) under IRC Sec. 708(b)(1)(B) because of a change in ownership of more than 50% of the LLC's capital and profits interest.

If an existing domestic eligible entity treated as a partnership terminates for tax purposes under IRC Sec. 708(b)(1)(B) or is involved in a transaction in which the partnership divides into two or more partnerships, the resulting new entity (or entities) automatically will be classified as a partnership with no further action required. Therefore, ASSG continues to be classified as a partnership.

If ASSG decides at this time it would like to be classified as a corporation as opposed to a partnership, the 60-month limitation in Reg. 301.7701-3(c)(1)(iv) will not prevent ASSG from making this election because ASSG did not make a prior election but instead was classified under the default rules of Reg. 301.7701-3(b).

Understanding the Default Classification Rules

Usually, Form 8832 (Entity Classification Election) need not be filed unless the entity wants to make an affirmative check-the-box election to change to corporate status. The default classification rule for new domestic eligible entities is that they are automatically treated as partnerships if they have more than one owner, and as sole proprietorships or unincorporated branches if there is only a single owner. Alternatively, such entities can elect to be treated as corporations.

Example 1-4: Electing entity status under the check-the-box regulations.

Casey and Carlton, both U.S. citizens, form All-Star Sporting Goods LLC (ASSG) on January 1. They each own 50% of ASSG. Their attorney has drawn up the agreement and filed all necessary forms with the Secretary of State to be an LLC. They want to be treated as a partnership for income tax purposes.

ASSG is considered an eligible entity that can choose to be taxed either as a corporation or a partnership. If no election is made, the default classification is that of a partnership. ASSG should simply file Form 1065 and indicate on the form that it is an LLC.

Timing of Election

An entity-classification election is effective on the date specified by the entity on Form 8832 or on the date filed if no date is specified on the election form. The effective date specified on Form 8832 may not be more than 75 days before the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days before the date on which it is filed, it will be effective 75 days before the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed.

Relief for a Late Election. For qualifying entities, relief is available for late elections for either initial classifications or changes in classifications. The election must be filed within 3 years and 75 days of the requested effective date. A qualifying entity must meet the following requirements:

a. it did not file Form 8832 timely because it (1) failed to obtain its desired classification either as of the date of its formation or on its classification becoming relevant under Reg. 301.7701-3(d) (which provides that a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes) or (2) failed to obtain its requested change in classification;

b. either the due date for the tax return of the entity's default classification (excluding extensions) for the tax year beginning with the date of the entity's formation has not passed or the entity seeking an extension of time to make an entity classification election timely filed all required federal tax and information returns consistent with its requested classification for all years it intended the requested election to be effective and no inconsistent tax or information returns were filed;

c. it has reasonable cause for its failure to timely make the initial entity classification election; and

d. three years and 75 days from the requested effective date of its classification election have not passed.

An entity that does not meet these requirements may request relief by applying for a letter ruling.

Identifying Tax Consequences Resulting from an Elective Change in Classification

Reg. 301.7701-3(g) describes how elective changes in an entity's classification are treated for federal tax purposes. The regulations provide four possible classification changes by election: (a) a partnership elects to be an association (taxed as a corporation); (b) an association elects to be a partnership; (c) an association elects to be a disregarded entity; and (d) a disregarded entity elects to be an association. The regulations detail the tax consequences resulting from each of these elective changes.

Reg. 301.7701-3(g) provides that if an association elects to be classified as a partnership, the association is deemed to liquidate by distributing its assets and liabilities to its shareholders. The shareholders then are deemed to contribute all of the distributed assets and liabilities to the partnership.

If a partnership elects to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association. Then the partnership is deemed to liquidate by distributing stock in the association to its partners.

An association electing to be disregarded as an entity separate from its owner is deemed to liquidate by distributing its assets and liabilities to its sole owner. On the other hand, if an entity that is disregarded as an entity separate from

its owner elects to be classified as an association, the owner is deemed to contribute all of the assets and liabilities of that entity to an association in exchange for stock.

Reg. 301.7701-3(g)(2)(ii) provides that a plan of liquidation is deemed adopted immediately before the deemed liquidation incident to an elective change in entity classification, unless a formal plan of liquidation that contemplates the filing of the change is adopted at an earlier date.

Reg. 301.7701-3(g)(3)(i) indicates that an election to change the classification of an entity is treated as occurring at the start of the day on which the election is effective. Transactions that are deemed to occur as a result of the classification change are considered to have occurred immediately before the close of the day before the effective date of the election.

Understanding the Effect of a Change in the Number of Members in an Entity

Reg. 301.7701-3(f) addresses a change in the number of members of an entity and the effect on its classification. If an association's membership changes, the classification is not affected. If an eligible entity classified as a partnership subsequently has only one member (and is still treated as an entity under local law), the entity will be disregarded as an entity separate from its owner. If a single member entity that is disregarded as an entity separate from its owner subsequently has more than one member, the entity is classified as a partnership as of the date the entity has more than one member. Guidance on the federal tax consequences of such changes are provided in Rev. Rul. 99-5 (when a single member LLC that is a disregarded entity becomes an entity with more than one owner classified as a partnership) and Rev. Rul. 99-6 (when one person buys all of the ownership interests in an LLC that is classified as a partnership causing the LLC's status as a partnership to terminate). The classifications can be changed by election if the entity is not subject to the 60-month limitation on elections.

Example 1-5: What happens when a multimember LLC becomes a single member LLC.

Assume the same facts as in Example 1-4. The next year, Paige buys out the rest of Casey's and Carlton's interests and owns 100% of ASSG. ASSG can no longer be classified as a partnership because Paige is the only member. Paige will now report ASSG's income and expenses on a Schedule C in her Form 1040 in accordance with guidance from Rev. Rul. 99-6. ASSG is disregarded as a separate entity as of the date of the buy-out. ASSG is not treated as a new entity for purposes of the 60-month limitation in accordance with Reg. 301.7701-3(f)(3), which indicates that a change in the number of members of an entity does not result in the creation of a new entity for purposes of the 60-month limitation. The 60-month limitation does not apply in this situation because ASSG never made an election, but instead relied upon the default classification under Reg. 301.7701-3(b). Therefore, ASSG can, if Paige desires, make an election at this time to be classified as a corporation without being subject to the 60-month limitation.

The types of transactions illustrated in Rev. Ruls. 99-5 and 99-6 are quite common and the rulings provide basic guidance, particularly for smaller businesses without a complex capital structure. However, practitioners should realize that there are many issues that are not addressed because the rulings (a) apply only to domestic LLCs, (b) do not take into account the effect of liabilities, (c) do not address the retention of assets and liabilities by the owner outside the LLC, and (d) do not address the potential application of IRC Sec. 704(c) to the deemed transaction.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Indicate which of the following entities would most likely be treated as a partnership under the check-the-box regulations?

   a. Associations.

   b. Co-owners in property.

   c. Branch.

   d. Joint venture.

10. Multi-owner entities that are treated as separate entities:

    a. May choose to have their existence ignored under the check-the-box regulations.

    b. Report gross income and deductions on the owner's Schedule C.

    c. May elect to be treated as a corporation.

11. Alex Smith is the only member in Arlington, LLC, which operates a men's clothing store. Arlington is treated as a disregarded entity under the default classification rules, and all of the LLC's income and expenses are reported on a Form 1040, Schedule C. The store generates $150,000 of income in 2010, which is all self-employment income. Alex's wife, Anne, does the company's bookkeeping and helps Alex out in the store. She does not receive a salary. How should the income be reported on Alex and Anne's income tax return?

    a. Alex reports 100% of the store's income on his Schedule C if they live in a community property state.

    b. Arlington, LLC, is treated as a partnership for federal taxes if electing treatment under IRC Sec. 761(f)(1)(A).

    c. The earnings are allocated between Alex and Anne causing additional SE taxes to be due.

12. The check-the-box regulations under Reg. Sec. 301.7701-3(g) provide for four possible elective changes in an entity's classification for tax purposes. Which of the following are allowable classification changes by election?

    a. A disregarded entity elects to be a partnership.

    b. An association elects to be a partnership.

    c. A disregarded entity elects to be a corporation.

    d. An association elects to be taxed as a corporation.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Indicate which of the following entities would most likely be treated as a partnership under the check-the-box regulations? **(Page 14)**

   a. Associations. [This answer is incorrect. An association is classified as a corporation per the Code.]

   b. Co-owners in property. [This answer is incorrect. Co-owners in property are not a partnership unless they carry on their trade or business for profit. Many co-owners agree to merely share expenses and maintenance, an arrangement that would not constitute a separate legal entity.]

   c. Branch. [This answer is incorrect. A branch is not a partnership. An LLC owned by another legal entity, such as a corporation, is treated as an unincorporated branch of the parent entity.]

   d. Joint venture. [This answer is correct. Joint ventures are generally organized as partnerships if two or more partners carry on a trade or business for profit according to the Code.]

10. Multi-owner entities that are treated as separate entities: **(Page 14)**

   a. May choose to have their existence ignored under the check-the-box regulations. [This answer is incorrect. Single-owner entities may choose to have their existence ignored for federal income tax purposes, not multi-owner entities.]

   b. Report gross income and deductions on the owner's Schedule C. [This answer is incorrect. Gross income and deductions of single-owner entities are reported on the appropriate individual owner's schedules, i.e. Schedule C, E or F, depending upon the type of business. This does not apply to separate business entities with multiple owners.]

   c. May elect to be treated as a corporation. [This answer is correct. Multi-owner entities may elect to be treated as a corporation. However, this is attractive only in limited circumstances.]

11. Alex Smith is the only member in Arlington, LLC, which operates a men's clothing store. Arlington is treated as a disregarded entity under the default classification rules, and all of the LLC's income and expenses are reported on a Form 1040, Schedule C. The store generates $150,000 of income in 2010, which is all self-employment income. Alex's wife, Anne, does the company's bookkeeping and helps Alex out in the store. She does not receive a salary. How should the income be reported on Alex and Anne's income tax return? **(Page 6)**

   a. Alex reports 100% of the store's income on his Schedule C if they live in a community property state. [This answer is incorrect. Any joint venture that is community property is considered to be owned 50/50 by each spouse, the earnings of the joint venture is allocated 50/50 between the husband and wife.]

   b. Arlington, LLC, is treated as a partnership for federal taxes if electing treatment under IRC Sec. 761(f)(1)(A). [This answer is incorrect. If Alex and Anne elect treatment under IRC Sec. 761(f)(1)(A), they are electing out of partnership treatment. Therefore, the spousal joint venture would not be taxed as a partnership.]

   c. The earnings are allocated between Alex and Anne causing additional SE taxes to be due. [This answer is correct. The passage of the Small Business and Work Opportunity Tax Act of 2007 provides that a qualified joint venture conducted by a husband and wife who file a joint return is not treated as a partnership for federal taxes. The earnings of the venture will be allocated to each spouse based on his or her respective interests for SE tax purposes.]

12. The check-the-box regulations under Reg. Sec. 301.7701-3(g) provide for four possible elective changes in an entity's classification for tax purposes. Which of the following are allowable classification changes by election? **(Page 17)**

    a. A disregarded entity elects to be a partnership. [This answer is incorrect. A disregarded entity may not be treated as a partnership. A disregarded entity has only one owner, while a partnership must have two or more owners.]

    b. An association elects to be a partnership. [This answer is correct. An association can elect to change its classification to a partnership or a disregarded entity per Reg. 301.7701-3(g).]

    c. A disregarded entity elects to be a corporation. [This answer is incorrect. A disregarded entity may elect to be treated as an association per Reg. 301.7701-3(g).]

    d. An association elects to be taxed as a corporation. [This answer is incorrect. An association can elect to change its classification to either a partnership or a disregarded entity per Reg. 301.7701-3(g).]

BECOMING FAMILIAR WITH LIMITED LIABILITY COMPANIES

The limited liability company (LLC) is available in all 50 states and the District of Columbia. An LLC combines the advantages of owning a corporation with those of operating as a partnership, while avoiding the limitations on ownership and single class of stock rules applicable to S corporations. A multimember LLC is taxed as a partnership for federal income tax purposes unless it elects to be taxed as a corporation. This allows the members to allocate income and loss in any manner that has substantial economic effect and to include a portion of the LLC's debt in the basis of their membership interest. While enjoying this flexibility normally available only to partnerships, LLCs also offer their members limited liability with respect to almost all LLC debts.

An LLC is a business entity formed under the state law provisions of an LLC statute. Each LLC statute is different, and each state has different requirements for forming, operating, and dissolving an LLC. Generally, an LLC is made up of members (rather than partners) who are all entitled to participate in the management of the LLC. However, most states allow members to elect managers to manage the LLC. Managers can be either members or nonmembers. A member in an LLC generally can assign his interest, but the assignee cannot become a member without the consent (usually unanimous or majority consent is required) of the other members. Some states prohibit the conduct of certain business through an LLC. All states allow single-member LLCs. Because of the diversity of state law provisions governing LLCs, a Uniform LLC Act has been drafted.

Most LLCs are created when the articles of organization are filed with the Secretary of State. The articles of organization, which are similar to articles of incorporation, usually contain only general information about the LLC, including its name, business purpose, registered agent, and principal office. Although not required in most states, an LLC usually has an operating agreement (similar to a partnership agreement) that outlines the duties, rights, and responsibilities of the members. Some states, while not requiring a written agreement, require that certain default provisions of the state LLC Act can be overridden only by provisions in a written agreement. If the LLC does not have an operating agreement, the default provisions of the state LLC statute govern the operations of the LLC (unless overridden by the articles of organization).

Some of the advantages of multi-member LLCs (classified as a partnership) include the following:

a. They offer limited liability to their members.

b. The number of members is unlimited.

c. Members may be individuals, corporations, trusts, partnerships, or other LLCs.

d. The double taxation affecting most C corporations is avoided. Income is passed through to the members for tax purposes under partnership principles.

e. Members can participate in managing the LLC.

f. Distributions to members do not have to be directly proportional to the members' ownership percentages as they do for S corporations.

g. They can have different classes of ownership.

Disadvantages of multi-member LLCs (classified as a partnership) include the following:

a. The transfer of interests is difficult. Although a member may transfer an equity interest in the LLC, the new owner does not necessarily possess all of the rights and attributes of a member.

b. All states have enacted LLC laws, but the laws that have been enacted vary from state to state. (A Uniform Limited Liability Act does exist; however, few states have adopted it.) Therefore, the LLC must determine how it will be treated for both tax and liability purposes in other states.

c. The various LLC laws are relatively new and untested in nontax matters, such as their actual ability to limit member liability.

d. State law and/or applicable professional standards may prohibit certain types of businesses from being operated as multi-member LLCs. For example, some states prohibit doctors from running their practices as LLCs.

Understanding the Extent of Limited Liability Protection

Under most state LLC statutes, members have certain financial obligations to the LLC under the articles of organization, operating agreement, or applicable state laws. These generally include obligations (a) to make capital contributions under an enforceable capital contribution obligation; and (b) to return any distribution prohibited by the statute, the articles, or the operating agreement. Fulfillment of these financial obligations is usually enforceable by the LLC's creditors. Consequently, a member has liability for LLC debts to the extent of any financial obligation to the LLC under the articles, operating agreement, or state law.

Furthermore, lenders and other creditors (e.g., landlords) frequently require that the owners of a closely held business, including an LLC, personally guarantee the entity's liabilities. Therefore, limited liability is compromised when a personal guarantee is voluntarily entered into by contractual agreement. Nevertheless, limited liability can still be valuable if the business is exposed to other liabilities or potential liabilities that are not covered by insurance. For example, the business might be exposed to potential environmental liabilities or it might produce or sell goods that expose it to potential consumer liabilities.

In some situations, limited liability may not be available to members of an LLC. For example, if a general partnership is converted to an LLC, the members of the LLC who were general partners of the partnership generally are liable for debts incurred before the conversion. Although there is very little guidance in this area, LLC members may be liable in the same situations where a shareholder in a corporation would be liable if the "corporate veil" were pierced. For example, shareholders and officers can be liable for certain environmental torts of the corporation and it seems likely that an LLC member (particularly one with management responsibilities) would be held liable in the same situation. Additionally, several state LLC statutes and regulations have established that LLC members are liable for state taxes owed by the LLC.

Understanding How Partnership Tax Rules Apply to LLCs Classified as Partnerships

If the LLC is treated as a partnership, the tax provisions of Subchapter K of the Internal Revenue Code (encompassing IRC Secs. 701–777) apply. In addition, other Code provisions applicable to partnerships (e.g., IRC Sec. 448 regarding the use of the cash method) will also apply to the LLC. LLCs classified as partnerships and their members are taxed as partnerships and partners for all federal purposes. The differences in taxation of LLCs generally stem from provisions that differentiate between general and limited partners. The LLC will file Form 1065 and issue Schedules K-1 to its members, who are treated as partners.

Converting a Partnership into an LLC

A partnership-to-LLC conversion can be structured in many ways. Most of these methods provide a relative degree of certainty regarding the tax treatment of the partners in the converting partnership and can be used with confidence.

Conversion by Certificate. Under the Revised Uniform Limited Partnership Act (RULPA), the conversion of a general partnership into a limited partnership, or vice versa, is provided for by the filing of a certificate. Several states have the same provisions for partnerships to convert to LLCs. A partnership that converts into an LLC by certificate is, under state law, the same legal entity as before the conversion. Guidance can be found in Ltr. Rul. 9525058. Although the ruling does not specifically provide that the conversion is by certificate, it does provide that "pursuant to the Act, all property owned by the converting partnership is vested in the LLC, all obligations of the converting partnership become obligations of the LLC, and any action or proceeding pending against the converting partnership may be continued as if the conversion had not occurred." The IRS concluded that the LLC will be considered a continuation of the partnership, and the conversion will not result in a termination under IRC Sec. 708.

Conversion by Merger. Most state LLC Acts have provisions governing the merger of a domestic LLC with other types of business entities. States generally allow a domestic LLC to merge with or into another domestic or foreign business entity, although some states limit this to mergers with a domestic or foreign LLC. The state LLC statute

should be reviewed to determine whether it allows an LLC and a partnership to merge, as well as the steps that must be taken to comply with the state merger rules. A merger is usually accomplished by executing a written merger plan and filing articles of merger with the Secretary of State. A filing fee normally must be paid when the articles of merger are filed, and some states have notification requirements at the time of a merger.

Transfer of Partnership Interests to LLC. Probably the most common method of converting a partnership into an LLC is the transfer of the partners' interests in the preconversion partnership to a newly formed LLC in exchange for membership interests in the LLC. The partnership is then liquidated and its assets are distributed to the LLC.

In Rev. Rul. 84-52, the IRS ruled that the conversion of a general partnership into a limited partnership is viewed as a contribution of the members' general partner interests to the limited partnership in exchange for limited partner interests. This deemed contribution does not result in gain recognition to a contributing partner under IRC Sec. 721, except to the extent such exchange results in a Section 752 deemed distribution from the partnership in excess of a partner's outside basis. The conversion is not treated as a termination of the existing partnership for tax purposes, and there is no change in the holding period for any partnership interest. Rev. Rul. 95-37 clarified that Rev. Rul. 84-52 is applicable to domestic partnerships converting into domestic LLCs (classified as partnerships) and vice versa. The federal tax consequences are the same even if the resulting LLC is formed in a different state.

Other issues that may arise in connection with this method of converting a partnership into an LLC are discussed in Rev. Ruls. 95-37 and Rev. Rul. 84-52, including the following:

a. If, as a result of a conversion, the partner/member's share of liabilities increases, the contribution of money deemed to occur increases the basis of the contributing partner/member in the postconversion entity.

b. If, as a result of a conversion, the partner/member's share of liabilities decreases, the distribution of money deemed to occur reduces the basis of the distributee partner/member in the postconversion entity (but not below zero). If gain is recognized by the distributee because the deemed distribution exceeds the basis of his interest, the gain recognized increases the distributee's basis in the postconversion entity.

c. The converting partnership's tax year does not close for any of the partners because the conversion is not a sale, exchange, or liquidation of the partners' interests under IRC Sec. 706(c)(2)(A).

d. Because there is no termination of the converting partnership, the LLC that results from the conversion need not obtain a new taxpayer identification number.

e. The federal tax consequences of converting a partnership into an LLC are the same whether the resulting LLC is formed in the same state or in a different state from the converting partnership.

Other Methods. Other ways for structuring a partnership conversion into an LLC include (a) the contribution of assets by the partnership to the LLC, followed by distribution of the LLC interests to the partners; and (b) the liquidation of the partnership followed by a contribution of assets by the partners to a new LLC.

Reductions in the Partner's Basis. Partners in a partnership and members in an LLC taxed as a partnership can include their allocable share of partnership or LLC debt in the basis of their ownership interests. Under IRC Sec. 752, recourse debts are shared based on how the partners or members share the economic risk of loss with respect to such debt, while nonrecourse debts are shared among the partners and members based on a three-tier system that is driven by the partner's or member's share of minimum gain and ownership of partnership or LLC profits.

The general partners of a limited partnership are liable for all recourse debts of the partnership. Accordingly, general partners include the partnership's recourse debts in the basis of their partnership interests because they share the economic risk of loss for the debt. Limited partners are generally not allocated any of a limited partnership's recourse debts. If debt changes from recourse to nonrecourse upon conversion of the partnership to an LLC, it is allocated to all the LLC members (both former general partners and former limited partners). This causes a reduction in the share of LLC liabilities allocated to the general partners and an increase in the share of LLC liabilities allocated to the limited partners. Since a decrease in a member's or partner's share of liabilities is treated as a distribution of cash under the Section 752 rules, general partners are deemed to receive a cash distribution

upon the conversion, which may result in gain recognition if the deemed distribution exceeds the basis of their LLC interests.

Even if there is no gain recognition, the general partners have a reduced basis against which to deduct future losses. This is not as serious a problem as it may seem if the general partners remain liable for debts or obligations of the partnership incurred prior to conversion. (Alternatively, the general partners could agree to guarantee the previously recourse debts of the LLC.) If this is the case, the debts are still recourse to the general partners and there is no reduction in the amount of basis. However, reduction in basis may occur over time as preconversion debts are replaced with postconversion debts.

All partners in a general partnership are liable for partnership recourse debts by operation of state law, so the partners all share in basis from recourse debt. Since the recourse debt is shared by all partners, conversion does not result in former recourse debts being reallocated to a group of members (i.e., former limited partners) who were not previously allocated basis with respect to the debt. Because recourse debts are allocated under a different set of rules from nonrecourse debt, the postconversion debts of the LLC may be shared by the members in a different way than such debts were shared by the partners. But since general partners usually remain liable for preconversion debts of the partnership, this is usually not a problem.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. An owner of an LLC is referred to as which of the following?

    a. Non-member.

    b. Partner.

    c. Member.

14. Indicate which of the following is an advantage to operating as an LLC.

    a. Transfer of interests is simple.

    b. All states have enacted uniform LLC legislation.

    c. Double taxation is avoided.

15. A partnership may be converted to an LLC under various methods. Which method involves liquidating the partnership?

    a. Conversion by certificate.

    b. Transfer of partnership interests to LLC.

    c. Conversion by merger.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. An owner of an LLC is referred to as which of the following? **(Page 22)**

    a. Non-member. [This answer is incorrect. An owner of an LLC is not referred to as a non-member.]

    b. Partner. [This answer is incorrect. Although an LLC is treated as a partnership for tax purposes, an LLC owner is not referred to as a partner.]

    c. Member. [This answer is correct. LLC owners are referred to as members.]

14. Indicate which of the following is an advantage to operating as an LLC. **(Page 22)**

    a. Transfer of interests is simple. [This answer is incorrect. Transferring interests in an LLC is difficult. Equity interests may be transferred, but new owners may not possess all of the rights and attributes of a member. This is a disadvantage to operating as an LLC.]

    b. All states have enacted uniform LLC legislation. [This answer is incorrect. LLC legislation has been enacted in all states and LLCs are available in all 50 states. However, the laws vary from state to state. The LLC must determine how it will be treated for tax and liability purposes in all states in which it does business, making this a disadvantage.]

    c. Double taxation is avoided. [This answer is correct. Because an LLC is treated as a partnership for tax purposes, the corporate double tax provisions are avoided.]

15. A partnership may be converted to an LLC under various methods. Which method involves liquidating the partnership? **(Pages 23–24)**

    a. Conversion by certificate. [This answer is incorrect. Conversion by certificate does not involve liquidating or terminating the partnership. The IRS considers the LLC a continuation of the partnership.]

    b. Transfer of partnership interests to LLC. [This answer is correct. Transfer of partnership interests to an LLC is the most common method. The partners' interest in the preconversion partnership is transferred to a newly formed LLC in exchange for membership interest in the LLC. The partnership is then liquidated and its assets are distributed to the LLC.]

    c. Conversion by merger. [This answer is incorrect. The merger of two partnerships is generally governed by IRS provisions. Conversion by merger does not liquidate the partnership.]

UNDERSTANDING LIMITED LIABILITY PARTNERSHIPS (LLPs)

Another type of entity that has appeared in the U.S. in recent years is the limited liability partnership (LLP) or registered limited liability partnership (RLLP). This type of entity is similar in many respects to the LLC. All states currently have an LLP statute.

Understanding the Differences between LLCs and LLPs

LLPs arose in response to the personal liability problems faced by partners in law and accounting partnerships, chiefly as a result of the many malpractice claims related to thrift and financial institution failures. In most states, the limited liability protection afforded to LLP partners and LLC members is the same. However, in some states, LLP partners remain personally liable for the commercial and other general obligations of the partnership, and for their own errors and omissions and the errors and omissions of persons under their supervision. But they generally are not liable for errors and omissions by their partners or by employees under another partner's supervision.

Because partners in an LLP generally enjoy a higher degree of limited liability than enjoyed by partners in a general or limited partnership, many state statutes require LLPs to carry a specific amount of liability insurance. The amount of insurance required can be as much as several million dollars.

Although from a liability limitation standpoint, LLCs may be preferable to LLPs, some states restrict the use of LLCs for certain professions. Additionally, although LLPs may be less popular in states that allow professionals to practice as LLCs, it may be much easier to obtain permission from state professional standards bodies to operate as an LLP.

The administrative burdens of converting an existing partnership to an LLP or adopting LLP status for a professional practice (for example, meeting the state board of accountancy rules) are minimal in comparison to converting to or forming an LLC.

Knowing the Key Tax and Nontax Considerations

LLPs (general partnerships) and LLLPs (limited partnerships) are partnerships under state law with modifications regarding personal liability. Consequently, LLPs have the benefits common to partnerships. Although LLPs were intended to be utilized by professionals such as lawyers and accountants, most LLP statutes do not limit their availability to only professional firms. However, some states allow only certain types of professional groups to utilize the LLP form of doing business.

Forming an LLP. Unlike the formation of an LLC, which generally requires the filing of articles of organization and drafting of an operating agreement, an existing partnership can usually become an LLP by simply filing a registration statement. No amendment of the agreement is otherwise required. Some states do require renewal of LLP status and the payment of an annual renewal fee. While the fee for filing an LLC's articles of organization is usually minimal, the fee for registering an LLP can be significant, particularly when the fee is a function of the number of partners. Beyond registering with the state of formation and paying any required fee, other appropriate steps in the formation process include: (a) transferring title to any assets contributed by the partners, (b) obtaining and maintaining the statutorily required level of insurance or capital, (c) drafting a partnership agreement, which is usually not required by statute, but is strongly recommended for general business reasons, (d) opening a bank account in the LLP's name, and (e) obtaining federal and state employer ID numbers (also required for income tax purposes).

Meeting State Insurance Requirements. As previously mentioned, some states require LLPs to maintain a specific amount of liability insurance. The cost of maintaining such coverage may be substantial. However, partnerships formed to conduct a professional services business, such as an accounting firm, generally will already carry significant amounts of malpractice insurance.

Understanding Partners' Liability for Debts. In most states, partners in an LLP and members in an LLC enjoy the same type of liability protection (i.e., they have no liability for debts of the entity or for the wrongful conduct of another partner or member). In some states, however, an LLP member is only protected from liability for the

wrongful conduct of another partner. In such states, an LLP partner remains jointly and severably liable for the LLP's debts.

Understanding Which Laws Govern LLPs. LLPs generally are formed and governed under the provisions of a uniform partnership act. LLCs, on the other hand, are formed and governed under the specific provisions of the state of formation's LLC act. Because different laws govern LLCs and LLPs, there may be significant differences in the rules pertaining to distributions, withdrawals, management, and many other matters. Practitioners should review state law provisions to determine the differences between the rules pertaining to partnerships and LLCs.

Choosing LLC Status for Single-member Entities. An LLP must have more than one member. An LLC, however, can have a single member. Under the check-the-box regulations, a single-member LLC is automatically treated as a sole proprietorship, branch, or division. Alternatively, a single-member LLC can elect to be taxed as a corporation.

Operating Outside the State of Formation

When an LLP conducts business outside of its state of formation, it is generally advisable to register as a *foreign LLP*. (LLPs formed within the state in question are termed *domestic LLPs*.) By registering, the foreign LLP obtains assurance regarding which jurisdiction's laws (the home state's or the foreign state's, as specified by the foreign state's LLP statute) will govern its operations in the foreign state. In addition, a foreign LLP may not be permitted to bring lawsuits in that state unless it is properly registered. However, some state LLP statutes simply fail to address the issue of foreign LLPs.

Usually the information requested on foreign LLP registration documents is similar to that required to register a domestic LLP. A fee may be charged.

The Uniform LLP Act provides that the laws of the state where the partnership filed its election to be an LLP apply to the entity's operations in other states. Note that the state of filing may not necessarily be the state of formation, although the two will be the same in most cases.

If an LLP's status is not respected in a foreign state, the apparent result is that the entity will be treated as a general partnership, with the resulting exposure to unlimited personal liability for the partners.

Converting a General Partnership into an LLP

In Rev. Rul. 95-55, the IRS confirmed that an existing general partnership can usually convert to LLP status without any real federal income tax consequences to the converting partnership or its partners. Mechanically, conversions can be accomplished in several different ways.

Converting via Registering as an LLP. Under most LLP statutes, conversion can be legally effected simply by registering the existing general partnership as an LLP and paying the required fee. The new LLP's partners are the same as the old general partners, and the state's partnership statutes continue to apply, subject to the modifications contained in the state's LLP law. Therefore, there is no need to transfer title to firm assets, pay property transfer taxes, or give any other legal significance to the conversion process. The assets and liabilities of the old partnership become those of the new LLP by operation of law. LLP partners who had personal liability for debts of the old general partnership usually remain personally liable for those debts after the conversion.

Typically, no approval is required from state professional bodies (such as bar associations and boards of accountancy) to convert an existing general partnership into an LLP, because the LLP is viewed as a continuation of the same entity.

Converting via Liquidation or Merger. Another approach to conversion is to cause the old general partnership to contribute its assets and liabilities to a newly formed LLP in exchange for LLP ownership interests (generally tax-free under IRC Sec. 721). The LLP interests are then distributed to the partners in liquidation of their interests in the old partnership (generally tax-free under IRC Sec. 731). Alternatively, the partners can contribute their interests in the old general partnership to the newly formed LLP in exchange for LLP interests (again, generally tax-free under IRC Sec. 721). The old partnership then distributes all its assets and liabilities to the LLP in liquidation (again, generally tax-free under IRC Sec. 731). Both liquidation approaches are relatively unattractive for legal reasons because state law may require title to partnership assets to be transferred to the new LLP.

Finally, state law may permit the old general partnership to merge with the newly formed LLP, with the LLP being the surviving entity. A conversion accomplished via a merger transaction is much cleaner than one accomplished via a liquidation of the old partnership. With a merger, the surviving LLP generally assumes all rights and obligations of the old partnership by operation of law without any need to transfer title.

Federal Income Tax Consequences. Per Rev. Rul. 95-55, the new LLP is considered a continuation of the old general partnership. In other words, the conversion does not cause a termination of the existing taxable entity under IRC Sec. 708. In fact, the whole transaction is viewed as a nonevent for federal income tax purposes. This is apparently the case whether the conversion is accomplished via the registration, liquidation, or merger route.

Specifically, Rev. Rul. 95-55 (when read with Rev. Rul. 95-37, which applies to LLC conversions) provides that the conversion of an existing general partnership into an LLP has the following tax implications:

- The new LLP is considered a continuation of the old partnership, meaning the entity's tax year continues and no new EIN is required. In addition, the LLP continues to use the old partnership's tax accounting methods and elections (including any Section 754 election). The LLP's holding periods for its assets include the holding periods of the old partnership.

- Former partners do not recognize gain except to the extent changes in their shares of liabilities would cause basis in their interests to fall below zero.

- If partners recognize taxable gains upon conversion because of deemed Section 752 distributions (from reductions in their shares of debts) and the old partnership has made a Section 754 election, the basis of LLP assets will be increased to reflect the gains pursuant to IRC Sec. 734(b). Otherwise, the conversion will have no effect on the basis of assets formerly held by the old partnership.

- Former partners obtain the same basis in their new LLP interests as they had in their old partnership interests, unless the conversion results in changes in their shares of liabilities. The holding periods for the new LLP interests tack on to the holding periods for the old partnership interests.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Personal liability problems faced by partners in law and accounting partnerships led to the formation of limited liability partnerships. Which of the following is correct regarding LLPs?

    a. LLP partners are not personally liable for commercial and other general obligations of the partnership.

    b. LLPs are allowed to avoid carrying liability insurance.

    c. LLP partners are personally liable for only their own errors and omissions.

    d. An LLC is easier to form than an LLP.

17. When comparing an LLC to an LLP, which of the following is true?

    a. Both LLCs and LLPs are formed and governed under the same provisions.

    b. Most states provide the same liability protection to LLC members and LLP partners.

    c. Both LLCs and LLPs are treated as partnerships for tax purposes and, thus, must have more than one owner.

    d. Both LLCs and LLPs must file articles of organization and draft an operating agreement.

18. When converting a general partnership to an LLP:

    a. The new LLP is treated as a new entity for tax purposes and must apply for a new employer identification number.

    b. A merger of a general partnership and an LLP will require the transfer of title of all partnership assets.

    c. The whole transaction is treated as a nonevent for tax purposes.

    d. Approval is required from state professional bodies to effect a tax free conversion.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. Personal liability problems faced by partners in law and accounting partnerships led to the formation of limited liability partnerships. Which of the following is correct regarding LLPs? **(Page 29)**

    a. LLP partners are not personally liable for commercial and other general obligations of the partnership. [This answer is incorrect. LLP partners may be personally liable for commercial and general obligations of the partnership in some states.]

    b. LLPs are allowed to avoid carrying liability insurance. [This answer is incorrect. Many states require LLPs to carry a specific amount of liability insurance.]

    c. LLP partners are personally liable for only their own errors and omissions. [This answer is correct. LLP partners are personally liable for their own errors and omissions but are generally not liable for the errors and omissions by their partners or by employees working under the supervision of another partner.]

    d. An LLC is easier to form than an LLP. [This answer is incorrect. In comparison, forming an LLP is much easier administratively than forming an LLC.]

17. When comparing an LLC to an LLP, which of the following is most accurate? **(Pages 29–30)**

    a. Both LLCs and LLPs are formed and governed under the same provisions. [This answer is incorrect. LLCs are formed and governed under the specific provisions of the state of formation. LLPs are formed and governed under the Uniform Partnership Act provisions.]

    b. Most states provide the same liability protection to LLC members and LLP partners. [This answer is correct. In most states, LLP partners and LLC members enjoy the same type of liability protection. In some states, LLP partners are only protected from liability for errors, omissions and wrongful conduct of another partner.]

    c. Both LLCs and LLPs are treated as partnerships for tax purposes and, thus, must have more than one owner. [This answer is incorrect. Although both are treated as partnerships for tax purposes, single-member LLCs are allowed and are treated as a sole proprietorship, branch, or division.]

    d. Both LLCs and LLPs must file articles of organization and draft an operating agreement. [This answer is incorrect. LLCs must file articles of organization and draft operating agreements, but LLPs must simply file a registration statement.]

18. When converting a general partnership to an LLP: **(Pages 30–31)**

    a. The new LLP is treated as a new entity for tax purposes and must apply for a new employer identification number. [This answer is incorrect. An existing general partnership may generally convert to an LLP without any federal tax consequences to the partners or partnership.]

    b. A merger of a general partnership and an LLP will require the transfer of title of all partnership assets. [This answer is incorrect. A conversion from a GP to an LLP will cause the surviving LLP to assume all rights and obligations of the old partnership and will not require title transfers for the partnership assets.]

    c. The whole transaction is treated as a nonevent for tax purposes. [This answer is correct. For tax purposes, the conversion of a general partnership to an LLP is not recognized as a transaction.]

    d. Approval is required from state professional bodies to effect a tax free conversion. [This answer is incorrect. Approval from the states is generally not required to accomplish a conversion from a general partnership to an LLP because the LLP is viewed as a continuation of the same entity.]

THE PARTNERSHIP ANTI-ABUSE REGULATIONS DEFINED

Aimed at abusive partnerships, Reg. 1.701-2 gives the IRS broad power to recast any partnership transaction that does not follow the intent of Subchapter K. If a transaction meets the following five part test of Reg. 1.701-2(a), the IRS cannot invoke the anti-abuse rules.

a. The entity is a bona fide partnership;

b. each transaction or series of related transactions has a substantial business purpose;

c. the form of the transaction is respected under substance over form principles;

d. the tax consequences to each partner and transactions between the partner and the partnership accurately reflect the partners' economic agreement; and

e. the tax consequences to each partner and transactions between the partner and the partnership properly reflect the partner's income.

The IRS can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.

The aggregate versus entity provision is not applicable if another Code section provides for entity treatment and its ensuing tax results. This provision could affect some common situations in which partnerships are traditionally used (for example, using a partnership to avoid the S corporation rules for stock ownership and forming a partnership to obtain or circumvent affiliated group status).

When an issue that may be affected by this regulation is considered on examination, any application of this regulation must be coordinated with both the Issue Specialist on the Partnership Industry Specialization Program Team and the IRS National Office (IRS Announcement 94-87).

In Legal Memorandum 200128053, the IRS determined a partnership created and terminated within 10 days was set up solely to take advantage of the Section 732 basis rules for distributed property. As a result, the IRS recast the transaction as a sale of the related assets and the subsequent creation of the partnership.

To achieve tax results that are consistent with the intent of Subchapter K, the IRS can recast transactions as follows:

a. the partnership can be disregarded in whole or in part, and the assets and activities considered to be owned and conducted by one or more of the partners;

b. one or more of the partners of the partnership can be treated as a nonpartner;

c. the accounting methods of the partnership or a partner can be adjusted to clearly reflect income;

d. the partnership's items of income, gain, loss, deduction, or credit can be reallocated; and

e. a claimed tax treatment can be adjusted or modified.

The regulations list a number of factors that may be indicative, but do not necessarily establish, that a partnership is not consistent with the intent of Subchapter K. These factors are solely for illustration and are not the only factors that may be considered in making a determination regarding the intent of the partnership. The significance of any factor depends on all the facts and circumstances. If the five part test of Reg. 1.701-2(a) is met, these factors do not apply.

A partnership with potential exposure to the anti-abuse regulations can strengthen its position by (a) documenting the partnership's business purpose and analyzing its current and projected cash flows to show that funds are available to finance the business plan, (b) evaluating the tax benefits and their consistency with the partners' economic agreement, and (c) analyzing the effect of partnership treatment on the partners' aggregate tax liabilities.

HOW TO ELECT OUT OF PARTNERSHIP STATUS

As this course illustrates, partnership status is accompanied by a set of specialized tax rules that may not always be beneficial. The Code permits limited classes of partnerships to elect out of taxation under the partnership rules (or out of selected portions of the partnership rules). The election out of partnership status is available only if the income of the partnership members can be adequately determined without computing the partnership's income, and the arrangement is (a) an investing partnership or (b) an operating agreement. Certain short-term arrangements by securities dealers for underwriting, selling, or distributing a particular issue of securities may also be excluded.

While the election permits the arrangement to escape most of the rules governing the taxation of partnerships (which may not always be advantageous), it does not completely negate the existence of the partnership for tax purposes. Neither will it necessarily permit the arrangement to escape the effects of partnership status when applying tax rules that are outside the portion of the Code (Subchapter K) directly governing the taxation of partnerships and partners.

Qualifying as an Investing Partnership

An investing partnership is eligible for exclusion from the partnership rules if the participants—

a. jointly engage in investment transactions;

b. own the property as co-owners;

c. reserve their right to separately take or dispose of their shares of the investment properties;

d. do not actively conduct any business; and

e. do not authorize any person(s) to acquire or dispose of investments in a representative capacity.

In IRS Notice 2004-53, the IRS requested comments on the conditions that must be satisfied for an investing partnership to elect to be excluded from the partnership rules of Subchapter K.

Qualifying as an Operating Agreement

An operating agreement can be excluded from the partnership rules if its principal purpose is not "recycling, manufacturing, or processing" for nonmembers, and if the participants—

a. engage in the joint production, extraction, or use of property;

b. own the property as co-owners in fee, under lease, or under another form of contract granting exclusive operating rights (Rev. Rul. 82-61);

c. reserve the right to separately take in kind or dispose of their shares of any property produced, extracted, or used; and

d. do not jointly sell services or the property produced or extracted.

Each participant can delegate authority to sell its share of the produced or extracted property for short periods of time that do not exceed the lesser of "the minimum needs of the industry" or one year. This operating agreement exclusion is most commonly used in connection with joint operating arrangements covering oil, gas, or other mineral leases and horse breeding syndicates, but is not limited to such situations. Participants in a joint operating agreement can elect out of partnership status only if the operating agreement does not create an association taxable as a corporation.

The availability of this election may be significant if the participants are unsure of the status of their arrangement. When eligible participants wish to avoid taxation as a partnership, the practitioner should advise them to make the election as a precaution.

Electing to Be Excluded from the Partnership Rules

Regulations prescribe two methods of making the election to be excluded from taxation as a partnership. First, the organization may file a statement attached to a properly executed blank partnership income tax return (Form 1065). The blank return must be filed no later than the prescribed time for filing the partnership return (including extensions) for the first year for which the election is intended to be effective, and need only state the name or some other identification of the organization and its address.

Second, the organization is treated as electing to be excluded if it can be shown, based on the facts and circumstances, that, at and from the time of the organization's formation, the members intended that it be excluded from taxation as a partnership. This may be shown, for example, by an agreement among the members to be so excluded, or if members owning substantially all capital interests of the organization, from the commencement of the partnership, separately report and make tax elections with respect to their shares of the organization's income, deductions, and property.

An election under either method is effective unless, within 90 days of the organization's formation, an organization member notifies the IRS that he (a) desires that Subchapter K apply and (b) has notified all other members by registered or certified mail. (This 90-day deadline will usually pass before the time for making the election arrives.)

Once made, an election may not be revoked without IRS approval unless the organization ceases to qualify for the exclusion. An application for permission to revoke should be submitted no later than 30 days after the start of the year for which revocation is sought.

> **Example 1-6: Electing out for joint investment activity.**
>
> Tom, Dick, and Harry each own a one-third interest in certain joint investments. They do not carry on a trade or business and wish to be excluded from the partnership provisions of the Code. To obtain this exclusion, they can file an affirmative election (i.e., a blank Form 1065 with the required statement) advising the IRS of their intention to be excluded from the partnership provisions. Alternatively, they may be able to prove that they intended to be excluded from the beginning of their investment activity. Factors considered include an agreement among all the parties to be excluded, made at the time the organization was formed, as well as the fact that all the parties reported their shares of income and expenses on their returns in a manner consistent with their intent to be excluded.

An entity classified as a partnership under the check-the-box rules can elect to be excluded from Subchapter K under Reg. 1.761-2. This election out generally is not available to LLCs. Most state LLC Acts preclude LLCs from electing out by providing that the LLC, not the members, owns the LLC's property. Additionally, most state Acts provide that an LLC member cannot demand a distribution of property.

In FSAs 200216005 and 199923017, the IRS held that limited partnerships were not able to elect out of partnership classification under IRC Sec. 761. This determination was based on the fact that the partnerships were formed under the respective states' RULPA (Revised Uniform Limited Partnership Act). Under the RULPA, partners of a limited partnership are considered to own partnership interests in the partnership. Ownership of a partnership interest does not necessarily give a partner the right to take and dispose of the underlying partnership property. For this reason, the IRS ruled that partners under RULPA are not co-owners of partnership property and cannot take their share of the property at will. Thus, they did not meet the requirement of Reg. 1.761-2(a)(2)(i) and were not an eligible entity for purposes of IRC Sec. 761(a).

Evaluating the Implications of Electing Out

In general, electing out affords co-owners with the most tax flexibility with the least administrative hassle. This means that—

a. co-owners make their own tax elections, and there is no need to coordinate tax planning among members,

b. there is no need for a complicated and expensive partnership agreement, and

c. there is no need to prepare and file partnership tax returns.

However, electing out may not be advisable if (not an all-inclusive list):

a. The partnership wants to make special allocations (for example, deductions for intangible drilling costs or depreciation).

b. The organization is unsure it meets the conditions to elect out. For example, oil and gas property co-owners may have jointly entered into a long-term gas marketing contract. An invalid election out means the tax elections made by the individual partners may be invalid because the elections should have been made at the partnership level.

c. The partners want to use a different accounting method than what they use themselves (since the partnership will select its own method of accounting).

The failure to recognize a business arrangement as a partnership and the resulting failure to elect out can have negative tax consequences. For example, partners in an oil and gas joint venture must elect to deduct intangible drilling costs (IDC) at the partnership level, unless they elect out and make their elections at the partner level. If no partnership return is filed, and no election out occurred, the individual participants' elections to deduct IDC incurred by the joint venture may be invalid.

Avoiding Partnership Status to Allow a Tax-deferred Exchange of Partnership Interest

Under IRC Sec. 1031(a)(2)(D), the general nonrecognition provisions of IRC Sec. 1031 regarding tax-deferred exchanges of like-kind property do not apply to exchanges of partnership interests. However, the IRS has held that the exchange of an interest in real property as a tenant in common for a fee interest (essentially, an unrestricted ownership) in real property qualifies for nonrecognition under IRC Sec. 1031.

Example 1-7: Avoiding partnership status to allow for a tax-deferred Section 1031 exchange of an interest in property.

Eugene and Victor were each recently given a 50% interest in the Shady Acres apartment complex by their Great Uncle Herbert. Eugene and Victor do not wish to own the apartment complex jointly; however, neither wants to recognize the taxable gain that would result from the sale of their interest in the complex. Victor recently acquired a duplex equal in value to a half interest in Shady Acres. He is willing to exchange the duplex for Eugene's interest in the apartment complex. Eugene, through his lawyer, has agreed to the exchange.

An exchange of a 50% partnership interest in Shady Acres for a fee interest in the duplex would not qualify as a tax-deferred exchange. For IRC Sec. 1031 to apply, Shady Acres should be deemed owned by Eugene and Victor as tenants in common and not as partners.

What if Eugene and Victor in Example 1-7 had each been given a 50% interest in a partnership owning Shady Acres? Could they have distributed an undivided interest in the property to each partner and later successfully transacted a tax-deferred Section 1031 exchange of the duplex for Victor's interest in Shady Acres? It appears that to meet the Section 1031 requirements, Victor and Eugene must hold the property distributed from the partnership for a sufficient period of time prior to making the exchange.

A PARTNERSHIP IS NOT MERELY CO-OWNERSHIP OF PROPERTY

A partnership exists for federal income tax purposes when two or more persons or entities join together, other than through a corporation or a trust, to carry on a trade, business, financial operation, or other venture and divide the resulting profits. Arrangements that are not partnerships under local law may be partnerships for federal income tax purposes, and a partnership under local law may be taxed as something other than a partnership for federal tax purposes.

Co-ownership of property that is maintained, kept in repair, and leased or rented does not constitute a partnership for tax purposes unless the co-owners also actively carry on a business or other venture with the purpose of producing and dividing a joint profit. The profit may consist of joint production that is divided and taken in kind by the co-owners.

Regulations indicate that a partnership exists if apartment building co-owners lease space and "in addition provide services to the occupants either directly or through an agent." However, providing customary tenant services does not cause co-owners to be classified as partners. If co-owners, acting jointly either directly or through an agent, provide additional noncustomary tenant services, it is likely that the arrangement will be classified as a partnership.

The behavior of co-owners toward one another and toward third parties will also be examined. For example, if co-owners hold themselves out as partners, they might assume that status for tax purposes. Likewise, if they alter other aspects of their relationship, for example, by entering into an agreement prohibiting a sale by either party of any interest in the property except as part of a joint sale, or by creating a capital repair fund into which they deposited a percentage of rentals that could not be withdrawn except by mutual agreement, their arrangement may be classified as a partnership.

Example 1-8: Distinguishing partnerships from co-ownership of property.

Abbie and Bart own undivided half interests in an apartment project. Under state law they are co-tenants, not partners. They have not considered themselves partners for tax purposes. Each has been depreciating his or her share of the property on a separate depreciation schedule, and they have made separate tax elections regarding the property. Abbie and Bart have negotiated an agreement with MGT, an unrelated corporation, whereby MGT will (1) negotiate and execute leases; (2) collect rents and other payments; (3) pay taxes, assessments, and insurance charges related to the property; (4) maintain and repair the project; and (5) arrange for or furnish customary tenant services such as heating, air conditioning, water, trash removal, and cleaning of common areas.

The customary tenant services previously listed are furnished to tenants at no charge above their basic rent. Abbie and Bart pay MGT a percentage of the project's gross rentals for performing these services. MGT withholds its fees from the collected rents and pays the remainder directly to Abbie and Bart individually. For an additional charge, MGT also provides other services to tenants such as attended parking. MGT retains all revenues and is responsible for all costs associated with these additional services. MGT, whether performing services for Abbie and Bart or performing services directly for tenants, determines the time and manner of fulfilling its obligations and supervises all persons involved in meeting those obligations.

MGT provides additional, noncustomary services to tenants, but it does so directly, not as an agent for Abbie and Bart. Moreover, MGT's compensation for these services is not collected as part of the rent owed to Abbie and Bart, but is separately paid to MGT by the tenants. For this reason their agreement with MGT will not cause them to be taxed as partners. However, their agreement with MGT is not the only fact that determines whether they are partners for tax purposes.

Under Rev. Proc. 2002-22, the IRS will consider ruling that an interest in rental real property is not a partnership interest if a number of conditions are met. While Rev. Proc. 2002-22 does not provide substantive rules and cannot be used for audit purposes, the IRS is unlikely to challenge fractional share arrangements that meet its criteria. Furthermore, the taxpayer can always request a letter ruling if certainty is desired and the dollars involved warrant the time and expense of preparing the request.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Before the IRS can invoke the anti-abuse rules under Subchapter K several requirements must be met. From the following list of requirements, select those which must be met.

    i. The partnership must be bona fide.
    ii. The form of the transaction is respected under substance over form principles.
    iii. The tax consequence to each partner and transactions between the partner and the partnership must properly reflect the partner's income.
    iv. The tax consequences to each partner and transactions between the partner and the partnership must accurately reflect the partners' economic agreement.
    v. Each transaction is disclosed on the partnership tax return.

    a. Only i. and ii. are correct.

    b. Only i., ii., and iii. are correct.

    c. Only i., ii., iii., and iv. are correct.

20. An investing partnership is eligible for exclusion from the partnership rules if the requirements are met. Which one of the following is a requirement?

    a. The participants jointly engage in investment transactions.

    b. The participants must state in their operating agreement that they elect out of the partnership rules.

    c. The participants must actively conduct business.

21. In which of the following scenarios would a partnership exists for federal tax purposes?

    a. Bobby and Billy own a strip shopping center. They maintain the property and lease the retail store spaces to tenants.

    b. Eric and Erica own a high-rise apartment building. They operate the building and provide services such as dry cleaning and a concierge desk.

    c. Casey and Carrie own an office building. An agent is hired to lease the space and provide customary services.

    d. Tanner and Tyler own apartments. They hire a management company to operate and provide customary services to the tenants. The management company provides noncustomary services to the tenants and is paid directly by the tenants for those services.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Before the IRS can invoke the anti-abuse rules under Subchapter K several requirements must be met. From the following list of requirements, select those which must be met. **(Page 35)**

    i. The partnership must be bona fide.
    ii. The form of the transaction is respected under substance over form principles.
    iii. The tax consequence to each partner and transactions between the partner and the partnership must properly reflect the partner's income.
    iv. The tax consequences to each partner and transactions between the partner and the partnership must accurately reflect the partners' economic agreement.
    v. Each transaction is disclosed on the partnership tax return.

    a. Only i. and ii. are correct. [This answer is incorrect. Tests i. and ii. are not the only tests listed above indicated for invoking the anti-abuse rules.]

    b. Only i., ii., and iii. are correct. [This answer is incorrect. Tests i., ii., and iii. are not the only tests indicated for invoking the anti-abuse rules.]

    c. Only i., ii., iii., and iv. are correct. [This answer is correct. Tests listed in i. through iv. are required, but not v. In addition, each transaction must have a substantial business purpose.]

20. An investing partnership is eligible for exclusion from the partnership rules if the requirements are met. Which one of the following is a requirement? **(Page 36)**

    a. The participants jointly engage in investment transactions. [This is correct. To be eligible for exclusion from the partnership rules, the participant must jointly engage in investment transactions. This is one of the five qualifications.]

    b. The participants must state in their operating agreement that they elect out of the partnership rules. [This answer is incorrect. There is no requirement for participants to include any clause in the operating agreement in order to be eligible for exclusion from the partnership rules.]

    c. The participants must actively conduct business. [This answer is incorrect. An investing partnership is eligible for exclusion from the partnership rules if NO active business is conducted.]

21. In which of the following scenarios would a partnership exists for federal tax purposes? **(Page 39)**

    a. Bobby and Billy own a strip shopping center. They maintain the property and lease the retail store spaces to tenants. [This answer is incorrect. Co-ownership of property that is maintained, kept in repair, and is leased or rented does not constitute a partnership for tax purposes.]

    b. Eric and Erica own a high-rise apartment building. They operate the building and provide services such as dry cleaning and a concierge desk. [This answer is correct. If co-owners, acting jointly either directly or through an agent, provide additional noncustomary tenant services, it is likely that the arrangement will be classified as a partnership.]

    c. Casey and Carrie own an office building. An agent is hired to lease the space and provide customary services. [This answer is incorrect. Regulations indicate that a partnership does not exist if apartment building co-owners lease space and provide customary tenant services through an agent.]

    d. Tanner and Tyler own apartments. They hire a management company to operate and provide customary services to the tenants. The management company provides noncustomary services to the tenants and is paid directly by the tenants for those services. [This answer is incorrect. The management company provides noncustomary services to tenants, but it does so directly, not as an agent tor Tanner and Tyler. The management company's compensation for the services is not collected as part of the rent owed to Tanner and Tyler, but is separately paid to the management company by the tenants.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TPSTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following types of businesses would be most likely to consider a form of business other than a partnership?

   a. Businesses where owners are employees.

   b. Oil and gas venture.

   c. Real estate investments.

   d. Private investment activity.

2. Which of the following statements is accurate regarding partnership rules?

   a. Partnership rules do not allow for investors to pool their assets.

   b. Partnership rules do not allow pass-through taxation.

   c. Investment partnerships can elect out of partnership rules.

   d. Investment partnerships are covered by standard partnership rules.

3. Of the following statements concerning a family partnership, which one is **inaccurate**?

   a. A noncorporate entity created by property transfer from individual(s) to the entity for the benefit of family members.

   b. Typically, parents transfer assets to a family partnership in exchange for partnership interests.

   c. Partnership interests acquired by parents are subsequently sold or gifted to the children.

   d. Children have the option to sell or transfer their interests, thereby resulting in liquidation of the partnership.

4. Under the tax laws, a partnership terminates if a 50% or greater interest in its capital and profits is sold or exchanged within a:

   a. 6-month period.

   b. 12-month period.

   c. 18-month period.

   d. 24-month period.

5. Which of the following statements is most accurate?

   a. Partners in any partnership are not liable for debts of the partnership arising from errors, omissions, negligence, or malfeasance committed in the course of the partnership by another partner.

   b. Partners in a limited partnership are not liable for debts of the partnership arising from errors, omissions, negligence, or malfeasance committed in the course of the partnership by another partner.

   c. Debts of the partnership arising from errors, omissions, negligence, or malfeasance committed in the course of the partnership by another partner are not the responsibility of partners in a limited liability partnership.

   d. Partners in a general partnership are not liable for debts of the partnership arising from errors, omissions, negligence, or malfeasance committed in the course of the partnership by another partner.

6. Which of the following entities is generally required to adopt the tax year of its majority owners?

   a. S corporation.

   b. Personal service organization.

   c. Partnership.

   d. Sold proprietorship.

7. Edward is a partner in Adobe, a partnership. He receives $30,000 for administrative services that he provides to the partnership. How will this be treated?

   a. The amount will be subject to taxation at the partnership and partner levels.

   b. The amount will be tax-free to Edward and will reduce Edward's basis in the partnership.

   c. The amount will be classified as a guaranteed payment and subject to self-employment tax.

   d. The amount will be recorded as partner salaries and taxes will be withheld.

8. How do most states tax partnerships?

   a. Partnerships are not directly taxed.

   b. Partnerships are taxed on their distributions.

   c. Partnerships are taxed on their income.

   d. Partnerships are taxed on their capital.

9. Business entities classified as corporations for federal tax purposes include all of the following **except:**

   a. Single-member LLCs..

   b. Associations.

   c. Insurance companies.

   d. Joint-stock companies.

10. If an eligible entity classified as an LLC effects a technical termination under Code Sec. 708(b), the new entity:

    a. Is not applicable because the technical termination provisions do not apply to LLCs.

    b. Must reincorporate and elect to be treated as a partnership under the check-the-box regulations.

    c. Must elect to be treated as a partnership on the first tax return of the new entity.

    d. Is automatically classified as a partnership.

11. If an eligible entity classified as a partnership and subsequently has only one member due to changes in ownership, then:

    a. The entity will be treated as a disregarded entity.

    b. The entity has 60 days to find another member to retain its partnership classification.

    c. The entity will automatically convert to a corporation.

    d. The entity will retain its classification as a partnership.

12. Which of the following is an advantage to organizing as an LLC?

    a. Tax free distributions are allowed and must be pro rata.

    b. The number of members is unlimited.

    c. LLCs are allowed and treated uniformly in all states.

    d. The LLC is automatically treated as a limited partnership.

13. Identify the tax effect of a decrease in a member's or general partner's liabilities.

    a. A taxable capital gain.

    b. A taxable ordinary gain.

    c. A deemed distribution of cash.

    d. There is no tax effect.

14. When comparing a limited partnership to an LLP or LLC, which of the following statements is most accurate?

    a. Partners in an LLP are general partners.

    b. Partners in a limited partnership enjoy a higher degree of limited liability than that of partners in an LLP.

    c. Partners in an LLP are limited partners.

    d. Members in an LLC are categorized as limited partners.

15. An LLP is formed by:

    a. Filing articles of organization.

    b. Drafting an operating agreement.

    c. Filing a registration statement.

    d. Do not select this answer choice.

16. If a general partnership is converted to an LLP, the conversion does **not** require which of the following?

    a. Registering as an LLP.

    b. Liquidating the general partnership and contributing the assets into a new LLP.

    c. Merging the general partnership into a newly created LLP.

    d. Payment of property transfer taxes.

17. If a partnership is examined by the IRS and it is determined that the anti-abuse regulations are applicable, the IRS may:

    a. Recast transactions to treat a partner as a nonpartner.

    b. Require that the partnership be dissolved or terminated.

    c. Recast and combine transactions as a series of step transactions.

    d. Issue a statement of noncompliance and require substantiation of all transactions.

18. IRS Regulations prescribe a method for electing to be excluded from the partnership rules. Listed below are several methods for making this election. Select the best answer from the following election methods.

    i. File a blank tax return by the applicable due date and attach a statement.
    ii. Show that at the time of formation, the members intended to be excluded from the partnership rules.
    iii. An organization member notifies the IRS within 30 days that he desires that Subchapter K apply.

    a. i. only.

    b. i. and iii.

    c. i. and ii.

    d. ii. and iii.

19. What is one benefit of electing out of the partnership rules?

    a. A different accounting method is preferred.

    b. There is no need to coordinate tax elections.

    c. The partnership wants to make special allocations.

    d. Do not select this answer choice.

20. Which of the following would qualify for nonrecognition under IRC Sec. 1031?

    a. An exchange of an interest in real property as a tenant in common for a fee interest in real property.

    b. An exchange of a partnership interest for a fee interest in real property.

    c. An exchange of a partnership interest for a partnership interest in a different partnership.

    d. Do not select this answer choice.

Lesson 2: Introduction to Accounting Transactions Unique to Partnerships

Learning Objectives:

Completion of this lesson will enable you to:

- Classify, define, and account for organizational costs.
- Classify, define, and account for start-up costs. Recognize amounts required to be capitalized under Code Sec. 263(a).
- Define publicly traded partnerships, utilize joint ventures with tax-exempt entities, and describe series partnerships and Limited Liability Companies.
- Recognize state partnership taxation issues.
- Utilize partnership agreements.

ACCOUNTING FOR ORGANIZATION, SYNDICATION, AND START-UP COSTS

Certain expenditures incurred before a partnership begins the active conduct of a trade or business may have to be capitalized rather than deducted currently. Such preopening expenditures generally fall into three categories: (1) organizational expenses, (2) syndication costs, and (3) start-up expenses.

Organization Costs

Organization costs are otherwise capitalizable costs incurred in the formation of the partnership (including legal fees, filing fees, and related costs). Organization expenses eligible for deduction or amortization include only those expenses incurred prior to the original due date (not including extensions) of the tax return for the year in which the partnership begins business operations. Under IRC Sec. 709(b), a partnership deducts organization costs for the tax year in which it begins business in an amount equal to the lesser of (a) the amount of organization costs incurred or (b) $5,000, reduced (but not below zero) by the amount by which the organization costs exceed $50,000. Any organization expenses in excess of the deductible amount are allowed to be amortized ratably over 15 years (180 months) beginning with the month in which the partnership begins business. Expenses incurred after the date the partnership begins business must be capitalized as nondeductible and nonamortizable expenses—regardless of whether the partnership makes an otherwise valid election under IRC Sec. 709(b).

Organization costs are expenses that are—

a. incident to the creation of the partnership,

b. chargeable to a capital account, and

c. of a character that, if the partnership had an ascertainable life, would be amortized over that life.

The last item, in essence, requires that the item be expected to benefit the partnership throughout its entire life. The expense must be incurred during a period that begins a reasonable time before the partnership begins business and ends on the due date (without regard to extensions) for the tax return covering the partnership year in which the partnership begins business. Eligible expenses include filing fees, legal fees to negotiate and draw up a partnership agreement, and accounting fees to organize the partnership. Expenses of acquiring assets, business start-up costs, and syndication expenses are not organization costs.

Because the nature of an expense determines whether it is eligible for treatment as an organization cost, practitioners should advise clients to keep detailed records to substantiate the amount and nature of such expenses. Moreover, where there is an opportunity to do so, the practitioner can assist in justifying the largest reasonable allocation to such costs. In the case of a syndicated partnership, for example, there may be expenses that could relate to either organization costs or nondeductible syndication expenses. Accounting services may relate to

setting up partnership books and accounting systems (deductible/amortizable) or to preparing financial projections or other representations to be presented to prospective investors (nondeductible). Legal expenses can relate to preparing and filing partnership documents (deductible/amortizable) or to providing securities advice and preparing and filing offering materials (nondeductible). Professional expenses can also relate to tax advice regarding the partnership's structure (deductible/amortizable) or preparing a tax opinion or other tax disclosures required by securities laws or to promote marketing interests to prospective investors (nondeductible). By becoming involved early on, the practitioner can help the partners negotiate and document these costs to support the largest reasonable allocation to deductible/amortizable expenses rather than to nondeductible expenses.

Example 2-1: Amortizing and deducting partnership organization costs.

Bert and Ernie formed Burntside Golf Club, a calendar-year partnership, to purchase and operate an existing golf course. Burntside's golf course opened under the new ownership on June 1, 2010. In addition to other expenses incurred prior to the commencement of business, Burntside paid $2,500 to attorneys for drafting its partnership agreement, $500 to accountants to organize its books, and $3,000 in wages for preparation and upkeep of the golf course prior to its June 1 opening.

Burntside can elect to deduct the $3,000 of organization costs incurred to draft the partnership agreement and set up the partnership books.

If Burntside is a cash-basis partnership and the $500 accounting fee is not paid until 2011, its 2010 deduction must exclude the portion of the total organizational costs attributable to that fee. The deduction for that amount is deferred to 2010, the year of the payment.

The wages paid for preopening golf course upkeep do not constitute a partnership organization cost, but may be deductible/amortizable as a business start-up cost (IRC Sec. 195, discussed below).

Syndication Costs

Costs incurred in the syndication of a partnership must be capitalized . However, unlike organization costs, no election is available to amortize these costs. Syndication costs include all expenses incurred in promoting the sale of a partnership interest, such as the cost of printing the prospectus, broker commissions, and the cost of a tax opinion if obtained to comply with securities laws and promote the marketing of partnership interests (Rev. Rul. 88-4). A deduction for syndication costs is not allowed even if the syndication effort is abandoned (Rev. Rul. 89-11).

Start-up Costs

Under IRC Sec. 195, expenses that are otherwise deductible as ordinary and necessary trade or business expenses if the partnership were actively engaged in a trade or business must be capitalized if they are incurred during the partnership's start-up period. A partnership is considered to be in the start-up period with respect to a particular activity until the active conduct of the associated trade or business begins. IRC Sec. 195 provides that a partnership can deduct in the year in which its active trade or business begins an amount of start-up costs equal to the lesser of (a) the amount of start-up costs incurred with respect to the active trade or business or (b) $5,000, reduced (but not below zero) by the amount by which start-up costs exceed $50,000. Any remaining start-up costs are amortized ratably over a 15-year (180-month) period. (Practitioners should be aware that pending legislation would increase these limits to $20,000 and $75,000, respectively.)

The types of costs affected by this rule include amounts paid or incurred in connection with—

a. investigating the creation or acquisition of an active trade or business;

b. creating a new active trade or business; or

c. any preopening activity that occurs in anticipation of the commencement of a trade or business.

Start-up costs include costs for the following items:

a. An analysis or survey of potential markets, products, labor supply, transportation, facilities, etc.

b. Advertisements for the opening of the business.

c. Salaries and wages for employees who are being trained and their instructors.

d. Travel and other necessary costs for securing distributors, suppliers, or customers.

e. Salaries and fees for executives and consultants, or for similar professional services.

The range of planning opportunities for up-front deductions has been restricted by case law and legislation. The practitioner must carefully analyze and classify initial expenditures to maximize tax advantages. The practitioner must first determine if the payment was for capital items or ordinary expenses.

For expenditures that are ordinary expenses, the practitioner must distinguish between those incurred in a trade or business and those incurred in the start-up phase. Expenses incurred in a trade or business are currently deductible while those incurred as start-up expenses must be capitalized and amortized under the following rules.

UNDERSTANDING THE SECTION 263(a) REGULATIONS

The regulations under IRC Sec. 263(a) are sometimes called the "*INDOPCO* regulations" named after the 1992 Supreme Court decision that generated seemingly endless controversies about when expenditures can be deducted currently under IRC Sec. 162 as opposed to being capitalized under IRC Sec. 263(a). Specifically, the *INDOPCO* decision encouraged the IRS to argue that expenditures that produce significant future benefits generally must be capitalized, even when they do not actually create or enhance a separate and distinct intangible asset.

In general, the regulations require the taxpayer to capitalize amounts paid to:

a. Acquire or create certain intangible assets that are specifically described in the regulations.

b. Create or enhance an intangible asset that is not specifically described in the regulations, but only if it actually constitutes a separate and distinct asset.

c. Create or enhance future benefits that may be identified in yet-to-be-published guidance as intangible assets that require capitalization under IRC Sec. 263(a).

d. Facilitate the acquisition or creation of an intangible asset described in items a. through c. above. This provision is primarily aimed at transaction costs.

e. Facilitate (1) the acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer or the target), (2) the acquisition by the taxpayer of an ownership interest in a business entity when the taxpayer and target entity are considered related parties after the transaction, (3) the acquisition of an ownership interest in the taxpayer, (4) certain business entity restructuring, reorganization, capitalization, and recapitalization transactions, (5) the formation or organization of a disregarded entity (such as a single-member LLC), (6) the acquisition of capital including a stock issuance or borrowing transaction, or (7) the writing of an option.

Treatment of Amounts Required to Be Capitalized under the Section 263(a) Regulations

Amounts required to be capitalized under the Section 263(a) regulations cannot be deducted as ordinary and necessary business expenses under IRC Sec. 162 or as expenses incurred for the production of income under IRC Sec. 212. Instead, capitalized amounts must generally be added to the tax basis of the related asset. Depending on the nature of the asset, amortization of the capitalized amount may (or may not) be allowed.

In the context of taxable acquisitions, amounts paid by an acquiring taxpayer that are required to be capitalized under Reg. 1.263(a)-5 are (a) added to the basis of the acquired assets if the transaction is treated as an asset acquisition for federal income tax purposes or (b) added to the basis of the acquired stock if the transaction is treated as a stock acquisition.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Organizational costs incurred in organizing the partnership could be which of the following?

    a. Costs incurred in investigating the acquisition of a new business.

    b. Costs incurred in syndicating the partnership.

    c. Accounting and legal fees incurred in starting up the business.

    d. Costs incurred for creating a new business.

23. The three general partners in Sage Partnership organize the business on July 1 of the current year. In organizing the partnership, they incur the following expenses:

Legal service for drafting the partnership agreement	$ 11,500
Accounting fees incurred in organizing the partnership	5,000
Filing fees	500
Syndication expenses	1,200

    If Sage Partnership makes a timely election to deduct and amortize qualifying organization expenses, how much amortization expense will the partnership incur in the current year?

    a. $5,000.

    b. $5,400.

    c. $5,800.

    d. $7,400.

24. The two general partners form Sage Partnership and organize a business on July 1, 2006. In organizing the partnership, they incur the following expenses:

Legal service for drafting the partnership agreement	$ 25,000
Accounting fees incurred in organizing partnership books	10,000
Legal fees to prepare and file offering materials	20,000
Syndication expenses	80,000

    Assume Sage Partnership made a timely election to deduct or amortize qualifying organization expenses. How much organization expense will be allowed in the current year?

    a. $5,000.

    b. $6,000.

    c. $6,666.

    d. $7,000.

25. Which of the following is treated as a deductible and amortizable start-up expenditure?

    a. Legal fees to prepare a partnership agreement.

    b. Costs incurred in investigating the creation or acquisition of an active trade or business.

    c. Advertisements for the opening of the business.

    d. Both b and c.

26. A new partnership incurred the following expenses before beginning business operations. Which of the following expenses may be deducted/amortized as start-up expenditures?

    a. The purchase of land and a building.

    b. Printing costs for the prospectus.

    c. Architect's fees for renovating the building.

    d. Promotional activities to attract tenants.

27. Generally, the Section 263(a) regulations require taxpayers to capitalize amounts:

    a. Paid for tangible assets that would normally be deducted as ordinary and necessary business expenses.

    b. Paid to acquire certain intangible assets described in the regulations.

    c. Paid for all expenses incurred for the production of income that is deducted under IRC Sec. 212.

    d. Paid for expenditures deductible under IRC Sec. 162 that do not produce significant future benefits.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. Organizational costs incurred in organizing the partnership could be which of the following? **(Page 47)**

    a. Costs incurred in investigating the acquisition of a new business. [This answer is incorrect. Per IRC Sec. 195, costs incurred in investigating the acquisition of a new business are start-up expenditures, not organizational expenditures.]

    b. Costs incurred in syndicating the partnership. [This answer is incorrect. Syndication fees are not organizational expenditures and are not amortizable.]

    c. Accounting and legal fees incurred in starting up the business. [This answer is correct. Accounting fees and legal fees incurred in starting up the business are treated as organizational costs, capitalized and amortized under IRC Sec. 709(b).]

    d. Costs incurred for creating a new business. [This answer is incorrect. Costs incurred in creating a new business are start-up expenditures, not organizational expenditures.]

23. The three general partners in Sage Partnership organize the business on July 1 of the current year. In organizing the partnership, they incur the following expenses:

Legal service for drafting the partnership agreement	$ 11,500
Accounting fees incurred in organizing the partnership	5,000
Filing fees	500
Syndication expenses	1,200

    If Sage Partnership makes a timely election to deduct and amortize qualifying organization expenses, how much amortization expense will the partnership incur in the current year? **(Page 48)**

    a. $5,000. [This answer is incorrect. The partnership may deduct $5,000 in organization costs but may also amortize the remaining cost basis over 15 years.]

    b. $5,400. [This answer is correct. Syndication expenses are excluded from amortization. The partnership may deduct $5,000 in organization costs plus the amortization of the remaining cost basis over 15 years. ($5,000 + ($17,000 − $5,000)/15 × 6/12 months.)]

    c. $5,800. [This answer is incorrect. Syndication expenses are excluded from amortization.]

    d. $7,400. [This answer is incorrect. Organizational expenses may be amortized by deducting $5,000 of the total cost plus amortization over 15 years of the remaining cost.]

24. The two general partners form Sage Partnership and organize a business on July 1, 2006. In organizing the partnership, they incur the following expenses:

Legal service for drafting the partnership agreement	$ 25,000
Accounting fees incurred in organizing partnership books	10,000
Legal fees to prepare and file offering materials	20,000
Syndication expenses	80,000

Assume Sage Partnership made a timely election to deduct and amortize qualifying organization expenses. How much organization expense will be allowed in the current year? **(Page 47)**

a. $5,000. [This answer is incorrect. The partnership may deduct $5,000 in organizational costs but this is not the only cost incurred.]

b. $6,000. [This answer is correct. Legal fees to prepare and file offering materials and syndication expenses are excluded from the definition of organizational costs. The partnership may deduct $5,000 in organization costs plus the amortization of the remaining cost basis over 15 years. ($5,000 + ($35,000 − $5,000)/15 × 6/12 months.)]

c. $6,666. [This answer is incorrect. Organizational costs include legal services for drafting the partnership agreement but not legal fees to prepare and file offering materials.]

d. $7,000. [This answer is incorrect. Legal fees to prepare and file offering materials and syndication expenses are excluded from the definition of organizational costs.]

25. Which of the following is treated as a deductible and amortizable start-up expenditure? **(Page 48)**

a. Legal fees to prepare a partnership agreement. [This answer is incorrect. Legal fees to prepare a partnership agreement are organizational expenditures.]

b. Costs incurred in investigating the creation or acquisition of an active trade or business. [This answer is incorrect. Costs incurred in investigating the creation or acquisition of an active trade or business are treated as start-up expenditures. However, this is not the only correct answer.]

c. Advertisements for the opening of the business. [This answer is incorrect. Advertisements for the opening of the business are treated as start-up expenditures. However, this is not the only correct answer.]

d. Both b and c. [This answer is correct. Both costs incurred in investigating the creation or acquisition of an active trade or business and advertisements for the opening of the business are treated as start-up expenses and may be amortized.]

26. A new partnership incurred the following expenses before beginning business operations. Which of the following expenses may be deducted/amortized as start-up expenditures? **(Page 48)**

a. The purchase of land and a building. [This answer is incorrect. The purchase of land and a building are capital expenses and are not amortizable as start-up expenditures.]

b. Printing costs for the prospectus. [This answer is incorrect. The cost of printing the prospectus is a syndication cost, not a start-up expenditure.]

c. Architect's fees for renovating the building. [This answer is incorrect. Architect's fees for renovating the building are capital expenses and not amortizable as start-up expenditures.]

d. Promotional activities to attract tenants. [This answer is correct. Promotional activities to attract tenants are treated as start-up expenses under IRC Sec. 195.]

27. Generally, the Section 263(a) regulations require taxpayers to capitalize amounts: **(Page 49)**

a. Paid for tangible assets that would normally be deducted as ordinary and necessary business expenses. [This answer is incorrect. Amounts required to be capitalized under Section 263(a) regulations do not apply to tangible assets.]

b. Paid to acquire certain intangible assets described in the regulations. [This answer is correct. Section 263(a) requires the taxpayer to capitalize amounts paid to acquire or create certain intangible assets specifically defined in the regulations.]

c. Paid for all expenses incurred for the production of income that is deducted under IRC Sec. 212. [This answer is incorrect. A Section 212 expense cannot be deducted and also capitalized under Section 263(a).]

d. Paid for expenditures deductible under IRC Sec. 162 that do not produce significant future benefits. [This answer is incorrect. The INDOPCO decision encouraged the IRS to argue that expenditures that produce significant future benefits generally must be capitalized.]

BECOMING FAMILIAR WITH PUBLICLY TRADED PARTNERSHIPS

Master limited partnerships, if publicly traded, are subject to tax as corporations regardless of how they would be characterized under traditional classification principles. Moreover, even if exempt from being taxed as corporations, they are subject to more stringent passive activity income and loss restrictions.

Tax Treatment of Publicly Traded Partnerships

Subject to exceptions discussed later for certain partnerships with passive-type income and certain existing partnerships, publicly traded partnerships (PTPs) are taxed as corporations.

For partnerships that become taxable as corporations, a tax-free incorporation is deemed to occur on the first day the partnership becomes subject to tax as a corporation (i.e., the rules of IRC Sec. 351 apply). Thereafter, income is taxed at the entity level, and distributions to partners are taxed as distributions from a corporation to its shareholders (with all the double taxation implications present in the taxation of corporations and shareholders).

Defining a Publicly Traded Partnership

A general or limited partnership is a PTP if the partnership interests are traded on an established securities market or are readily tradable in a secondary market or equivalent. IRC Sec. 7704 applies to all domestic and foreign entities treated as partnerships, including LLCs.

Notice 88-75 was issued to provide interim guidance in defining a PTP. According to this notice, partnership interests are not treated as readily tradable on a secondary market or the substantial equivalent if the interests are: (a) issued in certain private placements, (b) transferred pursuant to transfers not involving trading, (c) traded in amounts that meet the requirements of a 5% or 2% safe harbor, (d) transferred through a matching service that meets certain requirements, or (e) transferred under a qualifying redemption or repurchase agreement. Reg. 1.7704-1 subsequently changed some of the guidance under Notice 88-75.

Notice 88-75 established several safe harbors that Reg. 1.7704-1 has modified in certain areas. If applicable, they ensure a partnership will not be classified as a PTP.

Exceptions to Taxation of PTP as a Corporation

There are exceptions to the rule requiring that a PTP be taxed as a corporation. The exception requirements, found in IRC Sec. 7704(c)(1) and (2), state that a PTP will not be taxed as a corporation if 90% or more of the PTP's gross income is qualifying income, including interest, dividends, real property rents, gain from the sale or disposition of real property, income derived from the oil and gas and natural resources industries, gain from the sale or disposition of a capital asset held for the production of income, and gains from commodities or futures, forwards, and options with respect to commodities. Congress introduced legislation in 2007 (S. 1624 and H.R. 2785) to exclude income derived from a person acting as an investment advisor or providing asset management services. However, at the time of this publication, that legislation had not yet been passed. Although partnerships covered by these exceptions are not taxed as corporations, they are subject to more stringent passive activity loss and income restrictions, which are discussed in the following paragraph.

Identifying Special Passive Activity Provisions

Partnerships that escape taxation as corporations under the available exceptions are subject to more stringent passive activity loss restrictions. Each PTP is viewed as if it exists "in a bubble" for applying the passive loss rules. Except upon a taxpayer's disposition of his partnership interest, passive activity loss from an exempt PTP can be used only to offset passive income from that entity. (No similar limitation applies to passive credits.) Likewise, passive income from an exempt PTP can be offset only by passive losses from the same entity. In other words, passive income from PTPs cannot shelter passive losses from other sources. Upon a fully taxable disposition of the taxpayer's entire interest in such a partnership, any remaining unused passive losses are fully deductible.

Tax-exempt partners, such as charities and pension plans, must consider additional issues since a tax-exempt entity's distributive share of income from an exempt PTP, whether or not distributed, is taxed as gross income derived from an unrelated trade or business.

FORMING A JOINT VENTURE WITH A TAX-EXEMPT ENTITY

The IRS dislikes Section 501(c)(3) organizations serving as the general partner in a partnership or joint venture with a for-profit entity because of a concern the nonprofit will operate the partnership at least partly for the benefit of the other (for-profit) partners. Prior to 1982, a Section 501(c)(3) organization automatically lost its exemption if it became a general partner in a partnership in which for-profit entities or individuals were limited partners. Based on a 1982 court decision, the IRS acquiesced to the participation by Section 501(c)(3) organizations in limited partnerships if stringent guidelines are satisfied.

Subsequently, the IRS clarified the guidelines in Rev. Rul. 98-15. This ruling presents two contrasting situations, each relating to the formation by a nonprofit hospital and a for-profit entity of a limited liability company (LLC) that will be taxed as a partnership. An analysis of the ruling reveals several important points:

a. The exempt partner will lose its exemption if a private party can control or use the exempt entity's activities or assets for the benefit of the private party, unless the benefit is incidental to the accomplishment of exempt purposes. An exempt general partner can fail the Section 501(c)(3) operational test and lose its exemption simply because the structure of the partnership does not give it control, whether or not it exercises control in actual operation. The control must be in substance as well as form.

b. The issues related to an organization acting as a general partner also apply to a charity being a member in an LLC treated as a partnership for federal income tax purposes.

c. Although the ruling specifically deals with hospital joint ventures, it is not limited to the hospital sector and is presumably applicable to any joint venture involving an exempt entity as a general partner.

d. The activities of a partnership are attributed to its partners. Therefore, an entity's exempt status may be jeopardized by the activities of the partnership.

e. The nonprofit's exempt purpose (benefit to the community) must explicitly be put ahead of the partnership's profitability.

In Rev. Rul. 2004-51, a university invested in a 50/50 LLC with a for-profit corporation to conduct off-campus teacher training seminars. Since the LLC's activities (which were attributed to the university) were not considered to be a substantial part of the university's activities, the university's participation did not affect its exempt status. While this may suggest that control of the joint venture is less important when the LLC is conducting insubstantial activities, the IRS did note that the university approved the curriculum and instructors, and determined the standards for successful completion of the seminars. Furthermore, all transactions entered into by the LLC were at arm's length and for fair market value. And finally, the LLC's activities expanded the reach of the seminars to those who could not be accommodated at or travel to the university's campus.

BECOMING FAMILIAR WITH SERIES PARTNERSHIPS AND LLCs

A number of states (including Delaware, Illinois, Iowa, Oklahoma, Nevada, Tennessee, Texas, and Utah) have enacted provisions allowing for the creation of series limited partnerships or series limited liability companies (LLCs). The statutes allow this type of partnership or LLC to designate separate series (or divisions) within the entity into which assets and ownership interests can be segregated [Delaware Code Sec. 17-218(a); Delaware Code Sec. 18-215(a) (LLC Act)]. The series limited partnership or series LLC can be structured to take advantage of the segregation possibilities under the statute, allowing each series to stand alone. Each series can have its own business or investment purpose, classes of ownership interest, and liability limitations.

To date, the IRS has issued little guidance on series LLCs. Informally, the IRS has indicated that it will treat each separate series of a series LLC as a separate entity for federal tax purposes (Ltr. Rul. 200803004). In this ruling, the IRS concluded that each separate series of a series LLC was able to choose its own entity classification independent of the classification of the others.

Although few states have addressed state tax issues, the California Franchise Tax Board has indicated that California will view series LLCs as being multiple (separate) LLCs that must pay multiple California LLC annual taxes and fees. This is evident in the revisions to the instructions for filing Form 568, California Limited Liability Company.

Requirements for Establishing a Series LLC

For the liabilities of a particular series to be enforceable only against the assets of that particular series the following steps must be taken:

a. The operating agreement of the master LLC must identify the series.

b. The operating agreement of the master LLC must call for the limitation of liability.

c. Separate records for each series must be maintained.

d. Assets of each series and the master LLC must be held separately.

e. Notice of the limitation of the liability of the series must be provided in the master LLC's articles of organization.

The operating agreements of series LLCs should include very clear and stringent requirements that the separate identity of each entity be scrupulously maintained. They should also provide clear membership rules for each series as well as clear allocations of income, loss, credits, and distributions.

Some operating agreement provisions should attempt to provide a basis to defend against claims in non-series LLC states. Some of the issues that need to be addressed include:

a. Would a non-series LLC state permit the separation of each series LLC's liability for creditors and other claimants?

b. Does each series LLC have to hold actual title to property or can the parent LLC hold title, with a clear allocation of percentage title to one or more series?

c. Can one or more series hold a joint interest in property—if so, on what basis and how is that reflected in the LLC records?

d. Will the liability limitation provisions protect other series LLC property from environmental claims against another series LLC?

e. How will the bankruptcy courts in non-series LLC states deal with the bankruptcy of one of the series?

f. Since the parent LLC will be the entity registered to do business in a state, will a non-series LLC state attempt to tax all of the series LLC's income on some proportionate basis or limit the state tax to those series actually conducting business in the state?

Advantages of a Series LLC

Benefits of using a series LLC include—

a. avoiding the cost of forming multiple LLCs or subsidiaries;

b. the possibility of reducing administrative expenses and state filing fees, such as franchise tax fees required to be paid in some states for LLCs;

c. the ability to add new series within the LLC without additional filings with the Secretary of State;

d. the ability to dissolve a series within an LLC without affecting the other series within the LLC;

e. the ability to make tax-free transfers within the LLC; and

f. the ability to segregate liabilities within a series.

Potential Uses for a Series LLC

Asset Protection. The last item in the preceding list is the most important. In general, the debts, liabilities and obligations incurred, contracted for, or existing with respect to a particular series are enforceable only against that

series, and not against the assets of the LLC generally or any other series. For example, according to the Delaware statute [Delaware Code Sec. 18-215(b) (LLC Act)]:

> . . . the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and, unless otherwise provided in the limited liability company agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability company generally or any other series thereof shall be enforceable against the assets of such series.

Example 2-2: Using a series LLC for asset protection purposes.

Computers LLC is established to conduct a single unified business—the manufacture, sale, distribution, and repair of computers. The company will later develop in-house research and development capabilities. The assets of the company are divided among the following series: a) internal-to-the-box manufacturing; b) packing the case, keyboard, mouse, monitor, etc., for shipment; c) distribution; d) communications; and e) office operations. Computers LLC acquires the assets for the internal-to-the-box manufacturing operation from Lender A, the assets for the packing operation from Lenders B and Ba, the assets for the distribution operation (e.g., trucks, loading equipment) from Lender C, the assets for the communications operation from Lender D, etc.

Computers LLC includes with its filing with the Secretary of State notice on its certificate of formation that the Series "a" assets are exclusively limited to liability for Lender A's debts, that the Series "b" assets are exclusively limited to liability for Lender B and Ba's debts, and so forth.

The end result is that creditors of Computers LLC may not be able to satisfy their claims from all of the company's assets. For example, a janitorial service with a breach of contract claim against Computers LLC could not satisfy its contract claim against the Series a, b, c, or d assets. Its claim could only be satisfied by reference to the Series e (office operations) assets.

Flexibility in Business Arrangements

Each LLC in the series has flexibility to operate and make decisions independently of the other LLCs. For example, equity interests in an LLC can be divided without affecting equity in the other LLCs. Also, instead of a traditional merger, two businesses may contribute assets to separate LLCs in a series LLC with the LLC and series agreements specifying which rights and responsibilities are combined and which are kept separate.

Uncertainty Surrounding Series LLCs

Despite the benefits, a number of unanswered questions remain about the practicalities of the series limited partnership or LLC. For example, will a court be willing to allow creditors to "pierce the veil" and, if so, under what conditions? Or, if the various "series" are operated so independently, will the IRS determine that they should really be treated as separate entities? These are just some of the issues that will need to be resolved in the coming years.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. Passive losses in a publicly traded partnership:

    a. May be deducted only upon disposition of the entity.

    b. May be deducted to the extent of passive income from other sources.

    c. May be deducted to the extent of passive income from the same PTP.

    d. May never be deducted.

29. A tax-exempt entity as a partner in a partnership will lose its tax exempt status if:

    a. A partnership can control the activities of the tax-exempt entity.

    b. It serves as a general partner in a partnership.

    c. It serves as a limited partner in a partnership.

    d. The activities of the partnership do not benefit the community.

30. In a series limited partnership or LLC, within the entity:

    a. Only assets can be segregated.

    b. Only ownership interests can be segregated.

    c. Both assets and ownership interests can be segregated.

31. Which of the following is a benefit of using a series LLC?

    a. The ability to aggregate liabilities within a series.

    b. The ability to add a new series within the LLC with filing permission from the Secretary of State.

    c. The ability to make tax-free transfers within the LLC.

    d. The dissolution of a series within an LLC affects a dissolution of all other series within the LLC.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. Passive losses in a publicly traded partnership: **(Page 55)**

    a. May be deducted only upon disposition of the entity. [This answer is incorrect. Passive losses may be deducted upon disposition of the entity but passive income may also be offset by passive losses from the other sources.]

    b. May be deducted to the extent of passive income from other sources. [This answer is incorrect. Passive losses from a publicly traded partnership may *not* be deducted to the extent of passive income from other sources. Passive losses can be used only to offset passive income from that entity.]

    c. May be deducted to the extent of passive income from the same PTP. [This answer is correct. Passive losses in a PTP may be deducted only to the extent of passive income from the same PTP. Each PTP exists "in a bubble" for purposes of applying the passive activity loss limitations.]

    d. May never be deducted. [This answer is incorrect. Passive losses from a publicly traded partnership may be deducted in some situations.]

29. A tax-exempt entity as a partner in a partnership will lose its tax exempt status if: **(Page 56)**

    a. A partnership can control the activities of the tax-exempt entity. [This answer is correct. In Rev. Rul. 98-15, the IRS provides that an exempt partner will lose its exempt status if a private party can control the tax-exempt entity's activities or can control the tax-exempt entity.]

    b. It serves as a general partner in a partnership. [This answer is incorrect. Although the IRS dislikes tax-exempt organizations serving as a general partner in a partnership, tax-exempt entities may be a general partner in some circumstances.]

    c. It serves as a limited partner in a partnership. [This answer is incorrect. Tax-exempt entities may be limited partners in partnerships per the Code.]

    d. The activities of the partnership do not benefit the community. [This answer is incorrect. A tax-exempt entity's exempt status may be jeopardized by the activities of the partnership but there is no requirement that the activities of the partnership benefit the community.]

30. In a series limited partnership or LLC, within the entity: **(Page 56)**

    a. Only assets can be segregated. [This is incorrect. Assets may be segregated; in this instance, this is not the only correct answer.]

    b. Only ownership interests can be segregated. [This answer is incorrect. Although ownership interests may be segregated within the entity, in this instance this is not the only correct answer.]

    c. **Both assets and ownership interests can be segregated. [This answer is correct. Both assets and ownership interests may be segregated in either a series limited partnership or a series LLC.]**

31. Which of the following is a benefit of using a series LLC? **(Page 57)**

   a. The ability to aggregate liabilities within a series. [This answer is incorrect. One of the benefits of using a series LLC is the ability to segregate liabilities within a series.]

   b. The ability to add a new series within the LLC with filing permission from the Secretary of State. [This answer is incorrect. The ability to add a new series within the LLC without additional filings with the Secretary of State is one of the benefits.]

   c. The ability to make tax-free transfers within the LLC. [This answer is correct. One advantage to a series LLC is the ability to make tax-free transfers.]

   d. The dissolution of a series within an LLC affects a dissolution of all other series within the LLC. [This answer is incorrect. The ability to dissolve a series within an LLC without affecting other series within the LLC is a benefit to using a series LLC.]

STATE PARTNERSHIP ISSUES

For the most part, states generally follow the federal tax structure of treating partnerships as conduits for the partners, with the partners taxed on their share of partnership items. Some states, however, do subject partnerships to various taxes at the entity level. For example, New Hampshire assesses a business profits tax on partnerships' business profits. New York City and the District of Columbia impose an unincorporated business tax on partnerships. With this in mind, considerable thought should be put into where and how the partnership will be formed and in what states it will be doing business.

Recognizing the Different Definitions of Taxable Income

There are several differences between the federal and state definitions of taxable income. First, states are constitutionally forbidden from taxing interest income from obligations of the U.S., even though such income is taxable for federal income tax purposes. Interest on obligations of states and localities (municipal bonds) is tax-exempt for federal purposes but is often taxable by states, particularly if the interest relates to the obligation of another state. As a matter of course, partnerships should report to partners the interest income from municipal bonds by state (in addition to identifying interest on U.S. obligations), so each partner may properly apply the rules for the appropriate state.

The disallowance of interest expense relating to tax-exempt interest income differs between federal and state purposes because the definition of tax-exempt interest income differs. Interest expense traceable to interest income from a U.S. obligation is often not deductible for state purposes. Conversely, interest expense traceable to taxable interest income from a municipal bond is usually deductible for state purposes, even though the interest expense is disallowed for federal purposes. Partnerships should report interest expense related to such income by state.

For federal purposes, an expenditure giving rise to a credit is usually not deductible. For example, a deduction for wages is disallowed in the amount of the targeted jobs credit taken with respect to the wages. Whenever such a credit is not allowed for state purposes, the corresponding deduction should be allowed.

Other common modifications to federal income include the adding back of state taxes which are deductible on the federal return but not on the state return. Some states use depreciation methods that are different from those used on the federal return, requiring an extra set of depreciation tables to be kept for state purposes. In addition, some states do not allow a deduction for guaranteed payments to partners.

Handling Multistate Partnerships and Multistate Partners

While each state's laws determine how income is taxed in that state, most states tax interstate business income based on the taxpayer's level of business activity in the state relative to all its business activity. Business activity is usually measured by the amount of gross receipts (often referred to as sales), payroll, and property owned within and without the state (i.e., apportionment). However, each state has particular rules for determining the amount of business income and the apportionment factors.

An important issue is determining whether an entity's activities within a state are sufficient to give the state the right to tax its income. When the activities rise to that level, the business has "nexus" in that state. While each state's laws differ in the details, common themes usually apply to determine if the entity's activities create nexus.

Pass-through Interests Can Create Nexus. A corporate general partner is usually treated as engaging in the partnership's business activities. Thus, a corporate general partner usually has nexus in any state in which the partnership has nexus, even if it has no other ties to the state. Similar to a corporate general partner, a corporate managing member of an LLC probably has nexus in any state in which the LLC has nexus.

Some states have attempted to assert that nonresident limited partners have nexus in their state. One approach is to rely on the "direct ownership of property" theory, which treats the partners as directly owning their proportionate share of partnership assets. If this is correct, the partner is then treated as owning property in the state and may become subject to the state income tax. Another approach is to argue that the partnership is doing business in the state as the partner's agent, which results in the partner being treated as doing business there. Some states may

assert these same nexus arguments against nonresident nonmanaging LLC members. While these theories may be questionable, practitioners should be aware of a particular state's view of whether limited partners or nonmanaging LLC members can be taxed. State taxing authorities are becoming increasingly sophisticated and aggressive in pursuing tax revenue.

Apportioning Business Income. When a company has business activities in more than one state, its liability for state income tax normally is calculated by apportioning business income among the states in which it has nexus. Apportionment is the division of taxable income among the states by measuring the extent of business activity (most commonly by measuring gross receipts, payroll, and property within every state). While a few states allow business income to be allocated among the states based on separate accounting, most states use a mathematical formula for apportioning business income. Some states provide special formulas for apportioning the business income of companies within certain industries, such as transportation, insurance, or finance.

The Uniform Division of Income for Tax Purposes Act (UDITPA) was enacted in 1958 by the National Conference of Commissioners on Uniform State Laws and later adapted by the Multistate Tax Compact. The Act provides a model apportionment formula for multistate business income. The formula uses a ratio based on the business's gross receipts, payroll, and property within the state relative to total receipts, payroll, and property. The factors are weighted equally.

States that have not adopted the UDITPA may use a method similar to the UDITPA. Variations include a one-factor formula (usually based on receipts) or a two-factor formula of property and receipts. Some states give double weight to the receipts factor, which tends to shift more of the state's tax burden to companies with substantial sales in the state, but little property or payroll in the state. The formula tends to favor companies with a physical presence in the state, to the detriment of those that merely derive income from sales to customers in the state but maintain little or no physical presence.

The apportionment factor developed under one of these methods multiplied by business income (usually federal taxable income with state-required adjustments) determines business income taxable within the state. Partners who have multi-state operations and investments must determine, depending on the state, how apportionment factors are combined from the partnership and other sources to report state income tax.

Allocating or Apportioning Investment Income. The Uniform Division of Income for Tax Purposes Act (UDITPA) includes a model apportionment formula for multistate business income. It uses a ratio based on the business's gross receipts, payroll, and property within the state relative to aggregate receipts, payroll, and property. Most states (under UDITPA or similar rules) follow the apportionment method for investment type income (interest, dividends, capital gains and losses) earned as part of the regular trade or business. For instance, interest earned on business bank accounts is generally apportioned consistently with the rest of the business income. However, nonbusiness income is generally apportioned directly to the state of commercial domicile.

States vary in their treatment and definitions of business and nonbusiness income. Planners should research the respective state rules before making material investments or beginning operations in a new state to avoid unexpected state tax liability to its partners, especially in situations where business operations and investments are held in the same entity. Investment partnerships tend to fall under separate rules for each state and therefore bear additional planning efforts as well.

Composite Returns. Many states offer partnerships the ability to file composite returns on behalf of its partners. This alternative centralizes the compliance effort and can take the filing burden off the partners. The partnership is generally required to obtain a representation from each partner that they qualify for composite treatment and a waiver of certain claims. State tax remitted on the partners' behalf (for the composite return or other required state tax withholding) is generally treated as a distribution in kind unless partners are required to reimburse the partnership. The below example contains typical state conditions.

Example 2-3: Communicating state composite filing requirements to partners.

Croissant Real Estate, LP purchased an office building complex in Phoenix and began operations in 2010. After researching Arizona filing requirements, it sent the following form to its partners to obtain information regarding composite filing in Arizona. It also sent a cover letter explaining the form, as well as making the partners aware of state issues.

Croissant Real Estate, LP
Arizona Nonresident Composite Tax Return Affidavit and Waiver
Tax Year Ended December 31, 2010

AFFIDAVIT

1. The partner was not a resident of Arizona during the taxable year (1/1/2010–12/31/2010).

2. The partner (and spouse) do not have any income from sources within Arizona other than his distributive share of partnership income allocable to Arizona from Croissant Real Estate, LP.

3. Partner is not deceased.

4. The partner's tax year is a calendar year ending December 31, 2010.

I meet **ALL** of the above conditions and elect to be included in the Arizona Partnership Composite return to be filed by Croissant Real Estate, LP for the year ended December 31, 2010.

WAIVER

I waive my right to claim all allowable exemptions, subtractions and deductions. I understand that my Arizona tax is to be calculated directly upon my pro rata share of the entity income at the appropriate individual tax rate for the year.

Signature ________________________________

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. When computing partnership state taxable income, generally the partnership must:

    a. Pay tax on all items of income.

    b. Exclude deductions for interest expense related to federally tax exempt interest income.

    c. Include interest income from U.S. treasury obligations.

    d. Use state tax depreciation methods.

33. States have the right to tax income when the business has "nexus" in the state. Business activity within a state is generally measured using apportionment ratios consisting of:

    a. Gross receipts.

    b. Net income.

    c. Withholding taxes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. When computing partnership state taxable income, generally the partnership may: **(Page 62)**

    a. Pay tax on all items of income. [This answer is incorrect. Not all states require partnerships to pay tax on items of income.]

    b. Exclude deductions for interest expense related to federally tax exempt interest income. [This answer is incorrect. Interest expense related to state tax exempt interest income is not deductible. Tax exempt interest income differs between federal and state tax rules.]

    c. Include interest income from U.S. treasury obligations. [This answer is incorrect. The partnership must exclude income from U.S. treasury obligations for state tax purposes.]

    d. Use state tax depreciation methods. [This answer is correct. A common modification when calculating the difference between taxable income for federal income tax purposes and that of taxable income for state tax purposes involves the use of depreciation methods unique to state tax requirements.]

33. States have the right to tax income when the business has "nexus" in the state. Business activity within a state is generally measured using apportionment ratios consisting of: **(Page 62)**

    a. Gross receipts. [This answer is correct. Business activity is measured using the apportionment of gross receipts, payroll and property.]

    b. Net income. [This answer is incorrect. Business activity is measured using three criteria and net income is not one of the three.]

    c. Withholding taxes. [This answer is incorrect. Business activity is measured using the apportionment of payroll, not withholding taxes.]

DRAFTING PARTNERSHIP AGREEMENTS

This lesson discusses some of the more important considerations in drafting and reviewing partnership agreements. It presupposes that (a) a family limited partnership (FLP) will be formed, although many of the considerations will apply to nonfamily-related partnerships as well, and (b) the partnership agreement will be drafted by a knowledgeable attorney. While practitioners should not draft partnership agreements, they should have a basic understanding of what alternatives are available when handling certain issues, and what various provisions mean. (A good rule of thumb when reviewing a partnership agreement or other legal document is for the practitioner to focus on the financial and tax results, rather than the legal construction or validity, of the document's provisions.)

To the extent the partnership agreement is silent concerning a particular matter, state law, in the form of the Uniform Partnership Act or the original or revised Uniform Limited Partnership Act, will provide default provisions. The various uniform acts are adopted by a group known as the Conference of Commissioners on Uniform State Laws. A state legislature has the flexibility to adopt a uniform act in whole, in part with modifications, or not at all. This means that partnership law is not consistent from state to state, and there is no single correct format for the partnership agreement.

The statute's default rules should not be relied upon when partnership agreements are drafted. The default rules can change, thereby changing the partnership agreement without the partner's knowledge or approval. In addition, default rules will not always effectively deal with every aspect of an issue, or the partners may want to deal with partnership issues in a different manner than provided for in the default rule.

Operating Agreement

Although not required in most states, an LLC usually has an operating agreement (similar to a partnership agreement) that outlines the duties, rights, and responsibilities of the members. Several states do not require that this agreement be in writing. Some states, while not requiring a written agreement, require that certain default provisions of the state LLC act can be overridden only by provisions in a written agreement. If the LLC has no operating agreement, the default provisions of the applicable state LLC statute govern the operations of the LLC (unless overridden by the LLC's articles of organization).

Understanding General Drafting Considerations

The partnership agreement should be in writing, even if it is not required by state law. Each agreement should specify how it can be amended and that it contains the entire agreement of the partners. Such steps help ensure that a partner cannot argue that an oral agreement has been made with respect to an issue not dealt with in writing. An important issue to address is the business purpose of the entity, since a valid business or investment purpose is necessary to form any partnership.

The partnership agreement also should address (a) the partners' ability to transfer their interests, including any restrictions on disposing of the partnership interest; (b) the method used to determine the transfer price; (c) the rights of any assignee of a partnership interest; (d) the management structure of the partnership, including the determination of voting rights; and (e) the events that will cause dissolution and liquidation of the entity.

The partnership agreement needs to establish the underlying economic deal; i.e., how the partnership items will be allocated amongst the partners. Distribution rights for different classes of interests might differ. However, the allocation of partnership items among partners for federal income tax purposes can have serious income tax consequences under IRC Sec. 704, particularly IRC Secs. 704(b), 704(c), and 704(e).

Requirements of each partner's initial contribution as well as any additional capital contributions should be determined and included in the partnership agreement. Establishment of terms for any loans that are made from partners to the partnership should be noted in order to avoid disagreement in the future.

Differentiating General from Limited Partnerships

In a general partnership, all partners are personally liable for all partnership debts and obligations and generally participate in the partnership's management. Conversely, in a limited partnership, one or more partners have

limited liability with respect to partnership obligations. (However, a limited partnership must have at least one general partner.) A limited partner is typically liable for no more than the amount of any unpaid capital contributions or those liabilities expressly assumed or guaranteed. In exchange, the limited partner usually surrenders the right to participate in the partnership's management and agrees to restrictions on the transferability of the partnership interest.

Identifying Who Should Be the General Partner(s)

If the client and his advisers determine that a limited partnership will most effectively help the client reach his goals, the client must decide who will be the general partner(s), who the limited partners will be, and the powers and rights associated with each type of partnership interest. The general partners in an FLP usually are senior generation family members or an entity, such as a corporation or LLC, controlled by senior family members. There is no limit to the number of general partners a limited partnership may have.

Individuals as General Partners. When naming the general partner, consideration should be given to the management duties involved, since limited partners can have no management responsibilities under state law or the limited partners' liability protection will be lost.

Another factor to consider is how the partnership will continue in existence when the senior family member dies. The death of a sole general partner will terminate the partnership unless the partnership agreement contains a mechanism to replace the general partner. Thus, if the client feels strongly about having a sole general partner, consider having the partnership agreement provide for a successor general partner. The successor could be named outright in the agreement or be subject to appointment by the remaining partners, including the limited partners.

Alternatively, the client can name multiple individual general partners. For example, if a married couple is forming the partnership, both spouses can be named general partners, with one spouse named managing general partner. With multiple general partners, the death or withdrawal of one partner will not cause the termination of the partnership.

Business Entities as General Partners. Using a corporate general partner prevents the problem of partnership termination upon the death of a sole individual general partner. By eliminating the possibility that a sole general partner's death could cause the termination of the partnership, the partnership can be valued as a going concern using income-based and market-based valuation methods, which often produces a lower value than if an asset-based approach is used. In addition, a limited partner's ability to liquidate his interest will not be tied to the life expectancy of one individual general partner, increasing the likelihood for a valuation discount for lack of marketability.

Another advantage of having a corporate or LLC general partner is the liability protection for the corporate shareholders or LLC members. Since a general partner is liable for the debts and obligations of the partnership, the corporate or LLC shield should protect the shareholders (or members) from such exposure. Generally, an S corporation general partner is preferable to a C corporation because of the avoidance of double taxation. Use of an LLC also avoids double taxation and in some ways is more flexible than an S corporation. However, LLCs may have other limitations that may preclude them from being the optimal general partner.

Depending on state law, corporate stock may be reached by creditors of a shareholder of the corporation. In such situations, it is conceivable such a creditor could gain control of a limited partnership by first gaining control of the stock of a corporate general partner. This problem does not exist with noncorporate general partners, since their creditors can only obtain a charging order which makes them an assignee entitled only to the general partner's share of earnings and distributions, not outright ownership with voting rights. Therefore, the client should be made aware of the liability risks of using a corporate general partner.

The presence of a C corporation partner generally requires the accrual basis of accounting. However, if the partnership has less than $5 million in gross receipts, the presence of a C corporation partner will not cause the partnership to lose its ability to use the cash method. The impact of this requirement should be carefully evaluated before naming a corporate general partner, since the use of cash basis can offer greater flexibility and planning opportunities.

Trusts as General Partners. A parent might want to hold his or her own family partnership interest in a living trust in order to avoid probate and for other reasons. Alternatively, the client may decide to contribute family partnership interests to a grantor retained annuity trust (GRAT) to take advantage of additional valuation planning opportunities.

A trustee who is unrelated to and independent of the grantor ordinarily will be recognized as the legal owner of the partnership interest for income tax purposes. If the grantor is the trustee, the trust will be recognized as a partner only if the grantor represents and protects the interests of the beneficiaries in a fiduciary manner and does not subordinate the beneficiaries' interests to his own interest. The IRS will consider the following factors in such situations:

a. whether the trust is recognized as a partner in business dealings with customers and creditors; and

b. whether, if partnership income is not retained for the reasonable needs of the business, the trust's share of the income is distributed to the trust annually and then paid to the beneficiaries or reinvested for their benefit.

In light of the family partnership regulations, care must be taken to ensure the trustee represents and protects the interests of the trust beneficiaries. In addition, if the transferor of the partnership interest is also the trustee of the trust, the transferred interest may be includible in the transferor's gross estate upon his or her death under IRC Secs. 2036 and 2038. Finally, some trustees may refuse to administer a trust with an FLP interest because of administrative complexities, tax uncertainties, and potential liability exposure (since general partners are liable to third parties who deal with the partnership).

Selecting and Adding Limited Partners

Upon formation of an FLP, the contributing partners (e.g., parents) may own both general and limited partner interests. The limited partner interests may be acquired by other family members at formation, or may be gifted or sold to them by the parents. However, the general partner may retain some of the limited partner interests.

For valuation purposes, the parents' general and limited partner interests are often aggregated, increasing the value of the limited partner interests over what their value would have been if held alone. This increase results from the powers held by the parents as general partners (e.g., ability to liquidate the partnership), and may cause gift tax problems when the limited partner interests are later transferred.

Legally, any entity can be a partner, including individuals, corporations, trusts, and even other partnerships. The family partnership income tax rules of IRC Sec. 704(e) and the regulations thereunder indicate that an individual will be recognized as a partner only if such individual is the real owner.

Trusts as Limited Partners. Parents may prefer to give family partnership interests to a trust established for the benefit of an adult or minor child in order to restrict the child's ability to use or consume the asset or to protect it from the child's creditors. This arrangement also provides a layer of privacy for the parent, since the child would not be involved directly in the affairs of the partnership. Trusts established to hold family partnership interests for children are typically structured as Section 2503(c) trusts, Crummey trusts, or custodial accounts under the various Uniform Gifts or Transfers to Minors Acts.

Minors as Partners. A minor child is respected as a partner for income tax purposes only if he is competent to manage his own property and participate in partnership activities. Thus, the minor must possess sufficient maturity and experience to be treated by disinterested persons as competent to enter business dealings and otherwise conduct his affairs equally with adult persons, notwithstanding legal limitations of minors under state law. Accordingly, in most situations, FLP interests should not be transferred directly to minor children. A transfer of the interest to an independent trustee or guardian for the minor's benefit is an appropriate alternative.

Admission of New Partners. The Revised Uniform Limited Partnership Act, adopted in some form by most state legislatures, provides that new limited partners can be admitted to the partnership only with the unanimous consent of all other partners, unless the partnership agreement provides otherwise. By following this default provision of the Uniform Act, along with a provision in the agreement requiring an assignee of a partnership interest to have the unanimous consent of all partners to become a partner, the client can keep the partnership interests within the

family, protect the family's interests from creditors (and ex-spouses of family members), and minimize the value of the partnership interests for transfer tax purposes.

Nonfamily Member Partner. To maximize transfer tax savings, the client will want to structure the transferred limited partner interests in such a way that their value can be discounted for having a lack of control over partnership affairs. Theoretically, a lack of control could be established by requiring the consent of all partners to liquidate the partnership, since a sole limited partner could not force liquidation and thereby have access to his portion of the assets.

However, valuation discounts will be reduced if a partner or member of his family (alone or collectively) can remove this restriction and actually cause a liquidation of the partnership. One solution to this problem is to have a nonfamily member own a small partnership interest, which, when coupled with requiring the consent of all partners to liquidate, should preserve the discount. Family members for this purpose do not include aunts, uncles, nieces, nephews, or cousins.

Determining the General Partner's Rights and Responsibilities

A critical part of designing an FLP is determining the rights and responsibilities retained by the general partners and those assigned to the limited partners. The partnership agreement is the proper vehicle for delineating the assignment of the various rights and responsibilities among the various ownership interests. Such powers are considered by the appraisers in determining the value assigned to the transferred limited partner interests, and may also be subject to close scrutiny by the IRS due to perceived abuses. Gift tax returns require disclosure and explanation of valuation discounts.

Management Responsibilities. General partners assume management responsibility for the assets and operations of the enterprise. These responsibilities include managing the day-to-day operations of the enterprise, buying, selling, or leasing property on behalf of the partnership, entering into contracts, borrowing or incurring indebtedness on behalf of the partnership, making financial and tax accounting decisions and elections, and any other duties described in the partnership agreement.

Control over Assets. Many clients considering a family partnership prefer to retain control over the family's assets via their general partner status, including the power to determine if and when partnership distributions are made and the power to liquidate or withdraw from the partnership. The client may also want to restrict the transferability of partnership units by the limited partners, in order to retain ownership within the family unit. However, these wishes must be balanced against the need to have the partnership respected for tax purposes.

If one of the client's primary objectives is to minimize transfer taxes, the partnership agreement can assign as many control features as possible to the general partner interest (without crossing the line that would prompt the IRS to disregard the partnership). Control features generally are considered to have value. Theoretically, the more powers assigned to the general partner, the greater the value of the general partner interest and the greater the minority interest (lack of control) discount should be for the transferred limited partner interests.

Under IRC Sec. 704(e), the IRS has the ability to "undo" a family partnership income allocation that does not properly reflect the economics of services provided by the general partner or income allocations that lack substance. Actual distributions to donee partners represent strong evidence of the reality of the donee's interest. Nevertheless, a managing general partner may retain income at the partnership level to meet the "reasonable needs of the business" without creating a Section 704(e) problem. Thus, it would seem advisable to document the reasonable business needs, perhaps in the minutes of the partnership's annual meeting. The partnership agreement also can be used to emphasize the need to retain income at the partnership level to meet business objectives.

Compensation for Services. A partner's allocable share of partnership income is generally determined by the partnership agreement. However, in the case of family partnerships where certain partners' interests were acquired by gift, the donor partner must be allocated a reasonable amount of compensation for services rendered to the partnership for the allocation of partnership income to the donee partners to be respected by the IRS. To accomplish this, a management fee can be authorized that is structured as a guaranteed payment.

Right to Withdraw. The default language of the Revised Uniform Limited Partnership Act allows a general partner to withdraw from the partnership at any time and receive "fair value" for his interest (although the remaining

partners may be entitled to damages for breach of the partnership agreement). To prevent a general partner's withdrawal from terminating the partnership, the partnership agreement can provide that any general partner's interest will be converted to a limited partner interest upon withdrawal, and then the agreement's provisions governing the rights of the limited partners would apply to such interests.

The revised Uniform Limited Partnership Act (ULPA 2001), which was finalized in 2001 and has been adopted in 15 states at this time, does not follow the prior payment of "fair value" rule. The revised ULPA indicates that there will be no payout.

Structuring the Limited Partners' Interests

When structuring the partnership agreement, the donor/general partner often wants to retain as much control over assets as possible. Retained control features keep the power centralized in the hands of the general partner, and decrease the value of the limited partner units that have fewer control features. But as already noted, the retention of too much control may cause the donee's interest to be disregarded by the IRS for income tax purposes under IRC Sec. 704(e) and may cause transfer tax problems as well.

The partnership agreement should address the rights of the limited partners, including the extent to which limited partners can vote, admit new partners, transfer their interests, replace the general partner, withdraw from the partnership, and force a liquidation.

Participation in Management. Most state statutes restrict the authority of limited partners to participate in the management of the partnership, although the partnership agreement can give the limited partners the right to vote on certain matters (e.g., admission or removal of a general partner or the winding up of the partnership). The inability of a limited partner to participate in management or unilaterally replace a general partner should be a factor to be considered when valuing transferred limited partner interests.

Admission of New Partners. The partnership agreement can specify the procedures for admitting new partners. If the agreement is silent, state law controls, and the Revised Uniform Limited Partnership Act (adopted in some form by most states) stipulates that new partners can be admitted only with the written consent of all existing partners. ULPA (2001) removes virtually all written requirements, but does require that certain information be maintained in record form.

A partner generally can assign his or her partnership interest to a third party, in whole or in part, unless the partnership agreement provides otherwise. The assignee becomes entitled to distributions that the assignor would otherwise have received, but does not assume any other rights of the assignor (unless all partners consent). For this reason, FLPs are often used as vehicles to protect assets of the partnership from creditors of the partners. Under the laws of most states, a creditor can receive only an assignee interest, which is generally an illiquid asset, and not the partnership interest itself.

Transferability of Partnership Interests. Many clients who are interested in forming an FLP want to limit the ability of partners to transfer their interests outside the family, at least without the consent of the other partners. Such a provision helps preserve control over the assets and keep them within the family unit.

Transferability restrictions also help create lack of marketability discounts for gift tax valuation purposes, since limited partners will essentially own an asset they can not sell or liquidate. However, if the limited partner's right to sell his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable or where the interest may be required to be left in the business for a long term of years), such restrictions can provide strong evidence to the IRS that the transfer should be ignored for income tax purposes. Accordingly, it is important to demonstrate that a donee partner is not limited in his ability to sell or liquidate the partnership interest and will not suffer financial detriment in doing so. The ability of the limited partners to transfer their interests is also important to ensure the annual gift tax exclusion will be available for gifts (as a present interest, rather than a future interest) of limited partner interests.

One way to accomplish this is to give the remaining partners a right of first refusal, allowing them to match any outside offer to buy a limited partner's interest. In addition, the limited partners should be allowed to sell their interests to existing (family member) partners without restriction. The purchase price should be the FMV of the

interest at the date of sale, net of any applicable discounts (i.e., a fixed price should not be used). The purchasers or transferees are not admitted as partners unless it is so provided in the partnership agreement or upon a vote of the other partners. Accordingly, all a transferee (assignee) receives is a right to his share of partnership distributions.

The IRS may attempt to use IRC Sec. 2703 to attack an FLP arrangement that limits the limited partners' ability to transfer their interests. IRC Sec. 2703 requires certain tests to be met for gifts of the limited partner interests to family members to be respected.

Withdrawal of a Limited Partner. If a limited partner can withdraw from the partnership on short notice and receive his or her prorata share of the net FMV of the partnership's assets, the limited partnership interest is in reality a relatively liquid asset. Accordingly, it is doubtful an appraiser would allow much of a valuation discount for the partner's lack of marketability.

The Revised Uniform Limited Partnership Act provides that a limited partner may withdraw from the partnership upon six month's written notice and receive FMV for his interest if the partnership agreement does not specify a definite time for the dissolution of the partnership. Therefore, in states that have adopted this provision as their default rule, the partnership agreement can provide a fixed duration, or term of years, to prevent the limited partners from being able to cash out on six months' notice, thereby preserving the valuation discounts.

The IRS has attacked a term-of-years requirement as an "applicable restriction" that should be ignored for valuation purposes under IRC Sec. 2704(b). This argument was, in fact, used in TAMs 9723009, 9725002, and 9730004, when the IRS applied IRC Sec. 2704(b)(2) to disregard the restrictions on a decedent's ability to liquidate his or her interest. In Ltr. Rul. 9723009, the IRS explained that the decedent's right to liquidate her limited partner interest was more restrictive than state law and was thus an "applicable restriction" under IRC Sec. 2704, which should be disregarded for valuation purposes.

However, in 1999, the Tax Court addressed the IRS's interpretation of the Chapter 14 provisions of the Code with respect to IRC Sec. 2704(b). The Tax Court concluded the partnership agreement did not contain restrictions on liquidation that constituted "applicable restrictions" within the meaning of IRC Sec. 2704(b), and so did not affect the valuation of limited partnership interests that were transferred.

Ability to Cause a Liquidation. Since a common goal among many clients considering a family partnership is to retain as much control as possible, the client will often prefer that none of the limited partners be given the right to force a liquidation of the partnership.

Generally, the right of a single partner to unilaterally force a liquidation is considered to add value to the partner's interest. Conversely, the inability to cause a liquidation can theoretically cause a reduction in value of a partner's interest since such a limitation reflects a lack of control. However, the value of a transferred family partnership interest is determined without regard to any restrictions on the ability of the transferee partner to cause liquidation (of his interest or of the entire partnership) if (a) the restriction lapses after the transfer (e.g., upon death of the transferor), or (b) family members (alone or collectively) can remove the restriction.

Several exceptions to the Section 2704(b) valuation rules should be considered when structuring the partnership agreement to preserve valuation discounts for the lack of control. First, the presence of a nonfamily member partner (which could include an aunt, uncle, niece, nephew, or cousin), coupled with a requirement that 100% of all partners must consent to a liquidation of the partnership, prevents IRC Sec. 2704(b) from applying. Another exception applies if the restrictions on the ability of a partner to liquidate in the partnership agreement are no more restrictive than the default provisions of state law.

Allocations of Income and Loss among Partners

Partnerships generally have quite a bit of flexibility with respect to how income and losses are allocated among the partners. Generally, partnership allocations must have substantial economic effect, or be made in accordance with each partner's interest in the partnership, pursuant to IRC Sec. 704(b). These rules are designed to ensure that the tax consequences of each partner's share of partnership allocations conform to the economic consequences of those allocations. Typically, straightforward family partnerships do not have a problem complying with the general allocation rules.

However, family partnerships must comply with additional rules regarding allocations of tax items among partners. These rules are intended to prevent the use of family partnerships to shift income from a high-bracket taxpayer (parent) to a low-bracket taxpayer (child).

Care should also be taken when structuring the partnership to avoid causing adverse gift tax consequences under IRC Sec. 2701. This provision can cause the value of the parents' retained general partner interest to be zero for gift tax purposes, which in turn causes the value of partnership interests gifted to the children to be equal to the entire fair market value of the partnership assets. However, this harsh treatment can be avoided if the donor-partner's interest retains the same proportionate rights (i.e., to income, deduction, gain, and loss) as the donee-partner's interest, other than management rights and limitations on liability. Accordingly, the partners can be given distribution rights and an allocation of partnership tax items in proportion to their percentage ownership to avoid application of IRC Sec. 2701.

Business Purpose Requirement

For a partnership to be valid for tax purposes, the assets held by a partnership must be related to a trade or business, investment, or income-producing venture. For this reason, it is highly advisable to formally document the purpose of the partnership in the partnership agreement, and on an ongoing basis wherever possible (e.g., correspondence from the general partners to the limited partners, minutes of partnership meetings).

Many business, investment, and income-generating reasons exist for creating family partnerships. For example, a family partnership, particularly an FLP where the donor acts as managing general partner, enables the donor to transfer assets to family members, retain some degree of control over distributions, and not adversely affect the initiative and productivity of the donees (which could occur with outright gifts). Other business and financial reasons for creating a family partnership include centralizing control over the management and investment of assets, keeping assets within the family, lowering investment costs, and protecting assets against failed marriages.

In addition to preserving the partnership classification for tax purposes, a broad business purpose clause in the agreement helps support the general partner's ability to retain earnings at the partnership level to meet the reasonable needs of the business. The general partner's ability to retain earnings makes the limited partners' interests less valuable and eligible for enhanced valuation discounts.

Including Buy/Sell Provisions in the Agreement

Transferability of Partnership Interests. A fundamental purpose of a buy/sell clause in a family partnership agreement is to restrict the ability of the partners to freely transfer their interests and thereby ensure that only family members are partners. This is usually accomplished by limiting the situations when a partner can dispose of his interest to certain identifiable events, such as death, disability, bankruptcy, divorce, or retirement. At the same time, the buy/sell clause facilitates the creation of a market for the partnership interests at times when a partner may be in need of liquid assets. In a sense, it establishes an exit strategy for the partners at the inception of the partnership, which reduces the potential for conflict later, when a triggering event occurs.

Transferability restrictions help create lack of marketability discounts for gift tax valuation purposes. However, if a limited partner's right to sell his interest is subject to substantial restrictions (e.g., on the right to transfer the interest), the IRS may ignore the donee's interest for income tax purposes. Substantial restrictions on the right to sell may also cause loss of annual gift tax exclusions due to the lack of a present interest. Accordingly, it is important to show that a donee partner is not overly limited in his ability to dispose of the partnership interest and will not suffer financial detriment in doing so.

One way to accomplish a completed transfer is to give the remaining partners a right of first refusal that would allow them to match any outside offer to buy a limited partner's interest. Each partner should be given the right to purchase a prorata share of the selling partner's interest, and to the extent any interests go unpurchased, a prorata share of the unpurchased interest. In addition, the limited partners should be allowed to sell their interests to existing (family member) partners without restriction. If a limited partner attempts to transfer his interest to someone who is not an existing partner, the partnership agreement can provide that the transferee can acquire only an assignee interest, which entitles him only to the transferor partner's share of income and distributions. The assignee receives no management rights, withdrawal rights, or even the right to inspect the books and records.

Valuation Provisions. Buy/sell provisions should determine the purchase price of an interest to be transferred in a manner that establishes the FMV of the interest at the date of sale, net of any applicable discounts. A valuation method that results in a price that is less than FMV will be disregarded for transfer tax purposes, although the parties will be contractually bound by the terms of the agreement. If the IRS determines that the buy/sell agreement is a device to transfer property to family members for less than full and adequate consideration, it can redetermine the value of the transferred interest for transfer tax purposes.

Funding Provisions. In addition to specifying the triggering events and the method of valuing the transferred interests, buy/sell provisions should specify the terms and means of payment, when applicable. For example, the buy/sell clause can allow the limited partners to purchase the units on the installment basis and set the term and interest rate. Life insurance is often used, either in lieu of or in addition to an installment note, to fund the purchase of the interests upon a partner's death. It is often desirable to provide for a long-term payout when the buyout is the result of a partner's disability, divorce, etc.

The buy/sell agreement can be structured as a redemption agreement, where the partnership itself buys back the partnership units. In this case, the partnership may acquire life insurance to fund the purchase. Alternatively, the agreement can be a cross-purchase agreement, where the remaining partners are the purchasers, and they each own life insurance on each other. The tax treatment of these two different types of buy/sell agreements are different and should be analyzed before finalizing the agreement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Which of the following would have the final determination of allocations in a family limited partnership?

    a. The partnership agreement.

    b. The state law.

    c. The state legislature.

35. All of the following should be specified in a partnership agreement **except**?

    a. Partners' abilities to transfer partnership interests.

    b. Events that will cause dissolution and/or liquidation of the partnership.

    c. Partners' guarantees of liabilities.

    d. Allocation of specific partnership items.

36. Which of the following, if chosen as a general partner of a family partnership, causes the parent to avoid probate?

    a. A trust.

    b. An LLC.

    c. A corporation.

    d. An individual.

37. Identify which of the following regarding partnership agreements is correct.

    a. General partners do not have the right to withdraw from the partnership at any time.

    b. Partners may own both a general partnership and a limited partnership interest.

    c. A limited partner generally has no restrictions on transferability of ownership interest.

    d. A buy/sell agreement identifies which of the partnership assets may be sold outside the partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Which of the following would have the final determination of allocations in a family limited partnership? **(Page 67)**

    a. The partnership agreement. [This answer is correct. The partnership agreement should address how the partnership items will be allocated amongst the partners.]

    b. The state law. [This answer is incorrect. In the absence of a partnership agreement or where the agreement is silent concerning a particular matter, the state law will prevail.]

    c. The state legislature. [This answer is incorrect. The state legislature does not rule on the allocations, but their adoption of a uniform act will be the state law.]

35. All of the following should be specified in a partnership agreement **except**? **(Page 67)**

    a. Partners' abilities to transfer partnership interests. [This answer is incorrect. Partnership agreements should include specifications on a partner's ability to transfer his/her partnership interest.]

    b. Events that will cause dissolution and/or liquidation of the partnership. [This answer is incorrect. Partnership agreements should include provisions identifying events that will cause the dissolution or liquidation of the partnership.]

    c. Partners' guarantees of liabilities. [This answer is correct. Partners' guarantees of liabilities are typically specified in loan documents, not in the partnership agreement.]

    d. Allocation of specific partnership items. [This answer is incorrect. Each partner's allocable share of partnership items should be specified in a partnership agreement.]

36. Which of the following, if chosen as a general partner of a family partnership, causes the parent to avoid probate? **(Page 69)**

    a. A trust. [This answer is correct. A parent might want to hold his or her own family partnership interest in a living trust in order to avoid probate.]

    b. An LLC. [This answer is incorrect. An advantage of an LLC general partner is the liability protection for the LLC members.]

    c. A corporation. [This answer is incorrect. Using a corporate general partner prevents the problem of partnership termination upon the death of a sole individual general partner.]

    d. An individual. [This answer is incorrect. The general partners in an FLP may be senior generation family members, but naming an individual as general partner will not avoid probate.]

37. Identify which of the following regarding partnership agreements is correct. **(Page 69)**

    a. General partners do not have the right to withdraw from the partnership at any time. [This answer is incorrect. General partners under the Revised Uniform Limited Partnership Act have the ability to withdraw from the partnership at any time.]

    b. Partners may own both a general partnership and a limited partnership interest. [This answer is correct. Partners may own a general and a limited partnership interest in a partnership at the same time.]

    c. A limited partner generally has no restrictions on transferability of ownership interest. [This answer is incorrect. Many limited partnership agreements contain restrictions on the transferability of ownership interest.]

    d. A buy/sell agreement identifies which of the partnership assets may be sold outside the partnership. [This answer is incorrect. A buy-sell agreement specifies the ability of partners to transfer their interests in the partnership and does not relate to sales of the assets within the partnership.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TPSTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

21. When computing amortization expense for partnership organizational expenditures, how much may be deducted and amortized in the first year?

    a. The organizational cost divided by 5 years.

    b. Only $5,000.

    c. $5,000 plus the remaining cost divided by 5 years.

    d. $5,000 plus the remaining cost divided by 15 years times the number of months in business for the year.

22. Which of the following are treated as organization costs under Code Sec. 709?

    i. Attorney fees for drafting a partnership agreement
    ii. Accounting fees incurred to organize the partnership
    iii. Syndication fees.
    iv. Filing fees.

    a. Only i. and ii. are treated as organization costs.

    b. i., ii., and iii. are treated as organization costs.

    c. i., ii., and iv. are treated as organization costs.

    d. Do not select this answer choice.

23. Sturgeon Enterprises Partnership is formed with two general partners on April 1 of the current year. The partnership incurs the following costs. How much of the following are treated as organizational costs?

Purchase of land and building	$ 1,000,000
Legal fees for drafting partnership agreement	40,000
Management fees for operation of partnership	15,000
Architect's fees for renovating the building	30,000
Promotional activities to attract tenants	25,000
Tax planning fees for business entity choice	6,000

    a. $46,000.

    b. $53,000.

    c. $59,000

    d. $129,000.

24. Roger and Jana form Freese Partnership, a calendar-year partnership, to purchase and operate an existing public swimming pool. In organizing the partnership, they incur the following expenses: $10,000 for legal services related to the drafting of the partnership agreement and $5,000 for accounting fees incurred in organizing the partnership's books. Prior to the May 31st opening, the partnership incurred $4,000 in wages for preparation and upkeep of the pool. Which of the following statements is correct?

    a. The $4,000 in wages paid for preopening preparation and upkeep of the pool is an organization cost.

    b. Freese Partnership can elect to deduct $5,000 of organization costs incurred to draft the partnership agreement and set up the partnership books.

    c. Freese Partnership can elect to deduct $15,000 of organization costs incurred to draft the partnership agreement and set up the partnership books.

    d. The $5,000 for accounting fees incurred in organizing the partnership's books is a start-up cost.

25. Syndication costs:

    a. Must be capitalized and amortized.

    b. Include all costs incurred in promoting the sale of the partnership interests.

    c. Include all tax planning fees.

    d. Are deductible if the syndication effort is abandoned.

26. Start up expenses include all of the following expenses **except**:

    a. Accounting fees to organize the partnership.

    b. Advertisements for a grand opening.

    c. Travel costs to find a distributor.

    d. Survey costs to find potential markets.

27. The 1992 Supreme Court case that generated many controversies about the capitalization of expenses was which of the following?

    a. Specialty Restaurants.

    b. Madison Gas and Electric Company.

    c. INDOPCO.

    d. Brown.

28. Which of the following accurately reflects the placement of securities for a publicly traded partnership?

    i. Only a general partnership may be publicly traded.
    ii. Only a limited partnership may be traded on the secondary market.
    iii. A general partnership or a limited partnership may be traded on an established security market.
    iv. A general partnership or a limited partnership may be traded on a secondary market.

    a. i. and ii.

    b. ii. and iii.

    c. i. and iv.

    d. iii. and iv.

29. Which of the following statements regarding tax exempt organizations as partners in a partnership is correct?

    a. An entity's exempt status may be jeopardized by the partnership's activities.

    b. A tax exempt organization may be a general partner in a partnership but not an LLC.

    c. Tax exempt organizations will lose their exempt status if it becomes a general partner in a partnership.

    d. Tax exempt organizations may only serve as a limited partner in a partnership.

30. A tax exempt university is looking for a partner to help them expand course offerings to those who are unable to travel to the university to attend classes. Which of the following type of entity represents the university's best partner to meet the IRS requirements and preserve the university's tax exempt status in this endeavor?

    a. Publicly traded partnership.

    b. General partnership.

    c. Limited partnership.

    d. Limited Liability Corporation.

31. According to the text, which of the following states views series LLCs as being separate LLCs that must pay multiple LLC annual taxes and fees in that state?

    a. California

    b. New York.

    c. Tennessee.

    d. Mississippi.

32. When computing state taxable income at the partnership level:

    a. Interest income from state obligations is taxable.

    b. Interest income from U.S. obligations is not deductible.

    c. State taxes are deductible.

    d. Federal credits are always allowed by the states.

33. Indicate which of the following statements regarding state partnership tax issues is most accurate.

    a. Net income reported for federal tax purposes equals that reported for state tax purposes.

    b. Items of income and loss must be apportioned to each state based upon the UDITPA using a ratio based on gross receipts, payroll and property.

    c. Only partners, not partnerships, are required to pay state tax on partnership taxable income.

    d. Pass-through interests can create nexus for a corporate partner.

34. State composite returns:

    a. May be filed by the partnership on behalf of the partner.

    b. May be filed by the partners on behalf of the partnership.

    c. May include state income tax and state sales tax.

    d. May be filed by the partnership only if state tax withholding is due for the year.

35. In a limited partnership:

    a. Limited partners are liable personally for all partnership debts and obligations.

    b. Limited partners are liable only up to the amount of their investment.

    c. All partners are limited partners.

    d. All partners are general partners.

36. Which of the following pertains to a limited partner?

    a. Assumes management responsibilities.

    b. Retains control over the partnership's assets.

    c. Is restricted on the transferability of the partnership interest.

    d. Can force liquidation of the partnership.

37. Which of the following statements regarding Family Limited Partnership agreements is correct?

    a. Only general partners may make management decisions for the partnership.

    b. Limited partners have no voting rights.

    c. Limited partners may transfer their interests only to other existing limited partners.

    d. General partners, not limited partners, have the right to admit new partners.

GLOSSARY

401(k) plan: This type of profit-sharing plan provides an employee the option of having the employer pay an amount to his qualified plan, or make cash payments directly to the employee. The maximum annual deferral allowed under a 401(k) plan is $15,500 for 2007.

Acquisition costs: Costs directly associated with implementing the transaction.

Amortization: Amortization is the process of writing off the cost of an intangible or prepaid asset over its life. It is also the liquidation of debt through payments to a creditor.

Anti-abuse rules: An anti-abuse rule included in the regulations provides that any change in the property securing an indebtedness during the one-year period preceding the debt discharge will be disregarded if a principal purpose of that change is to affect the taxpayer's basis reduction.

Association: An unincorporated organization or group of people or entities that have united for a common business purpose.

Capitalizable costs: Expenditures incurred in the actual partnership formation including legal fees for drafting the partnership agreement, filing fees for registering the partnership with state and local authorities and related costs.

Cash or deferred arrangements (CODA): See 401(k) plans.

Centralization of management: In determining whether an entity or other unincorporated organization has the *corporate characteristic* of *centralized management*, the IRS examines whether any person (or any group of persons that does not include all participants or members) has continuing exclusive authority to make the management decisions necessary for the conduct of the organization's business. If management authority is delegated to a few participants, generally, the corporate characteristic of centralized management will be found to exist. If all participants are vested with management authority, the *corporate characteristic* of *centralized management* will generally be found to be lacking.

Check-the-box rules: "Check-the-box" refers to the method that allows eligible entities to choose tax classification using Form 8832 (Entity Classification Election).

Composite returns: Many states offer partnerships the ability to file "composite" returns on behalf of its partners. This alternative centralizes the compliance effort and can take the filing burden off the partners.

Eligible entity: A separate business entity that is not classified as a corporation.

Exempt organization: An organization exempt from tax.

Family limited partnership: A family partnership is a noncorporate entity created by the transfer of property from one or more individuals to the entity for the common economic benefit of family members.

Fringe benefit: A fringe benefit is a noncash benefit that is provided by the employer to an employee. The attractiveness of the fringe benefit rules is the employee receives a nontaxable (or partially taxable) benefit and the employer receives a deductible expense.

Guaranteed payments: Amounts partners receive for services they provide to the partnership are guaranteed payments (if the amounts are determined without regard to partnership net income). The costs of several of the most common types of fringe benefits provided to partners are treated as guaranteed payments (assuming they are provided regardless of partnership income and for services rendered in the partner's capacity as a partner).

INDOPCO regulations: In late 2003, the IRS released long-awaited final regulations under IRC Sec. 263(a), sometimes called the "INDOPCO regulations," named after a 1992 Supreme Court decision. The INDOPCO decision encouraged the IRS to argue that expenditures that produce significant future benefits generally must be capitalized, even when they do not actually create or enhance a separate and distinct intangible asset.

Joint venture: An enterprise participated in by associates acting together, with a community of interests, each associate having the right to participate in its management. For income tax purposes, a joint venture is treated as a partnership, not taxable in its own capacity, but regarded as a taxpayer for the purpose of computing its taxable income, which is distributable among the associates in the proportions agreed upon. Such distributive shares are reported by the associates on their individual income tax returns.

Large Partnerships: Large partnerships have at least $10 million of total assets or adjusted assets, or $35 million in gross receipts.

Limited liability companies (LLCs): An LLC is a business entity formed under the state law provisions of an LLC statute. An LLC combines the advantages of owning a corporation with those of operating as a partnership, while avoiding the limitations on ownership and single class of stock rules applicable to S corporations. A multimember LLC is taxed as a partnership for federal income tax purposes unless it elects to be taxed as a corporation.

Limited liability partnerships (LLPs): This type of entity is similar in many respects to the LLC. All states currently have an LLP statute. LLPs arose in response to the personal liability problems faced by partners in law and accounting partnerships. In most states, the limited liability protection afforded to LLP partners and LLC members is the same. However, in some states, LLP partners remain personally liable for the commercial and other general obligations of the partnership, and for their own errors and omissions and the errors and omissions of persons under their supervision.

Nexus: A business has nexus in a state when the entity's activities within the state are sufficient to give the state the right to tax its income. While each state's laws differ in the details, common themes usually apply to determine if the entity's activities create nexus.

Oil and gas venture: Historically, the most common arrangement for oil and gas ventures is co-ownership of the mineral rights in a property (via an oil and gas lease). When co-ownership of mineral rights is combined with a joint operating agreement, the arrangement is classified as a partnership for federal income tax purposes. Since oil and gas venture co-owners are considered to be individually involved with the joint production, extraction, or use of property, they can elect to be excluded from the partnership tax provisions (Subchapter K) if the arrangement qualifies as an operating agreement.

Operating agreement: Although not required in most states, an LLC usually has an operating agreement (similar to a partnership agreement) that outlines the duties, rights and responsibilities of the members.

Organization costs: Organization costs are otherwise capitalizable costs incurred in the formation of the partnership (including legal fees, filing fees, and related costs).

Partnership: A partnership is an association of two or more persons to carry on as co-owners a business for profit. Partnerships are governed in the various states of the United States by the Uniform Partnership Act (UPA). A partnership may be a general partnership, a limited partnership, LLC, or a joint venture.

Partnership agreement: The partnership agreement should be in writing, even if it is not required by state law. Each agreement should specify how it can be amended and that it contains the entire agreement of the partners. The partnership agreement also should address (a) the partners' ability to transfer their interests, including any restrictions on disposing of the partnership interest; (b) the method used to determine the transfer price; (c) the rights of any assignee of a partnership interest; (d) the management structure of the partnership, including the determination of voting rights; and (e) the events that will cause dissolution and liquidation of the entity. The partnership agreement needs to establish the underlying economic deal; i.e., how the partnership items will be allocated amongst the partners.

Passive activity: For taxable years after 1986, the Tax Reform Act of 1986 divided all income and losses into three categories: passive, active, and portfolio. If the taxpayer does *not* materially participate in an activity, the income or loss resulting is *passive.* The passive loss rules limit the amount of losses from passive activities that can reduce income from nonpassive sources.

Preopening expenses: See Organization costs.

Publicly traded partnerships (PTP): A general or limited partnership is a PTP if the partnership interests are traded on an established securities market, or are readily tradable in a secondary market or equivalent.

Rental activity: A rental activity constitutes an active trade or business only if significant services are furnished incident to the rentals. In general, apartment complex, office building, and shopping center operations constitute an active trade or business.

Retirement plan: The qualified retirement plans available through partnerships include defined benefit Keogh plans, money purchase Keogh plans, profit-sharing Keogh plans, Simplified Employee Pension Plans (SEPs), Savings Incentive Match Plans for Employees (SIMPLE Plans), Cash or Deferred Arrangements (CODAs), and 401(k) plans.

Series limited liability company or limited partnership: The statutes allow this type of partnership or LLC to designate separate series (or divisions) within the entity into which assets and ownership interests can be segregated. The series limited partnership or series LLC can be structured to take advantage of the segregation possibilities under the statute, allowing each series to stand alone. Each series can have its own business or investment purpose, classes of ownership interest, and liability limitations.

Single-member LLC: Single-member LLCs generally are classified as sole proprietorships if owned by an individual.

Start-up costs: Start-up costs are the costs to begin the operation of a business—usually the costs of capital assets, initial development of a market, and costs of production prior to the time that sales are achieved. The accounting treatment for these costs is capitalization (as "start-up costs," which are different from "organizational costs"), provided there is a future benefit and recoverability of the costs and amortization over a period of not less than 60 months.

Technical termination: A partnership terminates under the tax laws (i.e., a technical termination) if a 50% or greater interest in its capital and profits is sold or exchanged within a 12-month period.

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COMPANION TO PPC'S TAX PLANNING GUIDE—PARTNERSHIPS

COURSE 2

ALLOCATION OF INCOME AND LOSS (TPSTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course examines the allocation of a partnership's income, loss, gain, deduction, and credit among the partners. Lesson 1 discusses testing the validity of allocations and how the partnership agreement affects allocations. Lesson 2 will summarize the safe harbor rules and substantial economic effect rules. Lesson 3 discusses revaluations of book capital accounts and allocations in special circumstances.

PUBLICATION/REVISION DATE: April 2010

RECOMMENDED FOR: Users of *PPC's Tax Planning Guide—Partnerships*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of partnerships.

CPE CREDIT: 7 QAS Hours, 7 Registry Hours

7 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **April 30, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Allocations and the Partnership Agreement

Completion of this lesson will enable you to:
- Summarize the basics of testing the validity of a partnership's allocations.
- Recognize how a partnership agreement affects allocations.

Lesson 2—Substantial Economic Effect and the Safe Harbor Rules

Completion of this lesson will enable you to:
- Compare and contrast the safe harbor rules and allocations made according to partnership interests.
- Identify allocations that have economic effect and those that have a substantial effect.
- Summarize the rules for maintaining book capital accounts under the safe harbor rules.

Lesson 3—Allocations under Other Special Circumstances

Completion of this lesson will enable you to:

- Identify when mandatory and optional book capital account revaluations should be made and their consequences to the partnership.
- Summarize the ceiling rule and rules for Section 704(c) allocations, and compare and contrast the allocation methods that are available.
- Recognize allocations associated with nonrecourse liabilities, contributed property, credits, and foreign taxes.

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Lesson 1: Allocations and the Partnership Agreement

INTRODUCTION

A partnership is not subject to tax at the partnership level. The partnership's items of income, gain, loss, deduction, and credit are determined at the partnership level, allocated among the partners according to the partnership agreement, and reported to the partners on Schedule K-1 of the partnership income tax return (Form 1065). The partners then report these items on their own tax returns. In practice, the allocated amounts (commonly referred to as *K-1 items*) are distributive shares of partnership items.

In understanding the rules governing distributive shares, it is important to recognize that in every partnership transaction, there are (at least) two separate allocation systems involved:

a. allocations of economic results per the partners' economic agreement, and

b. allocations of tax items under applicable tax rules (both federal and state, which themselves may be different).

To make matters more complicated, additional accounting systems are frequently involved in reporting partnership income or loss, such as GAAP, regulatory agency accounting, and special financial accounting. This course discusses economic and tax allocations.

The economic and tax treatments of any partnership transaction are related, but they are not necessarily the same. The tax allocation rules of IRC Sec. 704 are designed to ensure that the allocation of tax results to the partners follows the allocation of economic results. In this course, and in analyzing any allocation, it is extremely important to understand whether a particular allocation is the economic treatment of the applicable item or the corresponding tax treatment of the item. Lesson 1 discusses tax versus economic allocations.

The allocation of income and loss is generally made according to the terms of the partnership agreement. However, if the allocations described in the partnership agreement do not have substantial economic effect, or are not in accordance with the partners' interests in the partnership, the accountant must allocate partnership taxable income or loss differently than that provided in the partnership agreement.

Learning Objectives:

Completion of this lesson will enable you to:

- Summarize the basics of testing the validity of a partnership's allocations.
- Identify ways that a partnership agreement affects allocations.

THE VALIDITY OF PARTNERSHIP ALLOCATIONS

Recognizing the Two Ways to Test Partnership Allocations

There are two avenues for testing the viability of a tax allocation under IRC Sec. 704 and its applicable regulations:

a. by showing that the allocation is "in accordance with the partner's interest in the partnership," or

b. by showing that the allocation has "substantial economic effect" under the safe harbor provisions.

Historically, partnerships were granted considerable latitude in allocating income, gain, losses, deductions, and credits among their partners for tax purposes. However, Congress, the courts, and the IRS have clarified and increased restrictions on partnership tax allocations. The general rule is that tax allocations must be in accordance with the partners' interests in the partnership, based on the partners' economic agreement while taking into

account all facts and circumstances. Generally, partners cannot allocate tax items in a manner inconsistent with allocations of the corresponding economic items. This ensures that if a partner reaps the economic benefit of an income or gain allocation, that same partner is allocated the income or gain for tax purposes. By the same token, if a partner bears the economic cost of an allocation of loss, that same partner should be allocated the loss for tax purposes.

The regulations provide a safe harbor—the substantial economic effect rules—with which a partnership can comply to avoid the uncertainties of the general and more nebulous partners' interests in the partnership rules. These safe harbor rules contain the detailed capital account bookkeeping rules that have received so much attention in tax accounting literature. The safe harbor capital account maintenance rules are really nothing more than an attempt to establish uniform bookkeeping procedures for the economic (not tax) results of partnership operations. Once the economic bookkeeping is done properly, the allocation of tax results among the partners must be made in a manner consistent with the allocation of the corresponding economic results.

Assume two equal partners own their partnership interests all year and have identical capital accounts. If the partnership agreement allocates the overall economic gain and loss between the two partners 50/50, it cannot allocate the tax results 75/25. Likewise, if the partners agree to specially allocate one item for economic purposes, they must allocate the associated tax results for that item on the same basis (subject to certain special rules discussed later in this course). For example, if the economic gain from the sale of a building is specially allocated 75% to one partner and 25% to another, the tax gain on the sale must also be allocated 75/25. In the presence of such a special economic allocation, the partners could not allocate the tax gain from the sale of the building on a 50/50 basis even though 50/50 is their basic, overall agreement.

Certain tax allocations do not have a corresponding economic element (in other words, the allocations do not affect the dollar value of a partner's interest). Examples include allocations of tax credits, percentage depletion in excess of cost, and deductions related to nonrecourse liabilities. Allocations of these items are made according to the partners' interests in the partnership under special rules set forth in the regulations.

IRC Sec. 704 is not the exclusive test for determining the validity and tax consequences of a tax allocation. Other tax principles also must be considered, such as whether the allocation involves assignment of income, misallocation of income among related parties, family partnerships, employee compensation, a gift, a sale, or other special situations. The allocation of income between related parties is governed by IRC Sec. 482, family partnerships by IRC Sec. 704(e), employee compensation by IRC Secs. 83 and 707(a), gifts by IRC Sec. 2501, and sales by IRC Secs. 707(a) and 1001. In other words, while an allocation may satisfy the Section 704(b) rules, other Code sections may still affect the tax treatment of that allocation.

Economic Substance Required for Partnership Transactions

Not only must partners have a profit motive in entering into a partnership arrangement, but the partnership transactions themselves must also have economic substance. Otherwise, the IRS disregards the investment for tax purposes. Furthermore, the IRS has the authority to recast a transaction if the partnership violates the anti-abuse regulations. The regulation will be violated if the partnership is formed or availed of in connection with a transaction having a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liabilities and the transaction is inconsistent with the intent of Subchapter K (the partnership section of the Internal Revenue Code). The intent of Subchapter K is set forth in five tests, all of which must be met:

- The entity must be bona fide.
- Each transaction must have a bona fide and substantial business purpose.
- The transaction must be respected under substance over form principles.
- The tax consequences must accurately reflect the partners' economic agreement.
- The tax consequences must clearly reflect the partners' income.

Failure to meet these tests authorizes the IRS to disregard the transactions, disregard one or more partners, disregard the partnership, or otherwise modify, ignore, or change the transaction to reflect "reality."

The anti-abuse regulations also give the IRS the power to treat any partnership as an aggregate of the partners, in whole or in part, if necessary to carry out the purpose of any Code provision or regulation.

In the recent *Countryside Ltd. Partnership* case, however, the Tax Court denied the Service's attempt to use the economic substance doctrine and the anti-abuse rule to recharacterize a partnership transaction. The case involved a liquidating distribution that was structured to defer tax by distributing property rather than cash to the partners. The partners conceded that tax avoidance was the sole motivation for the structure of the transaction. However, the court found that the transactions had economic substance and the anti-abuse rule could not be applied. While the employed means were designed to avoid recognition of gain by the liquidated partners, those means served a genuine, nontax, business purpose; i.e., to convert the liquidated partners' investments into 10-year promissory notes, an economically distinct form of investment.

Particular attention should be paid to partnerships involving related parties, since one of the "facts and circumstances" that the IRS will scrutinize involves related parties. However, the regulations take great pains to point out that all of the facts and circumstances must be considered in determining the validity of the transaction. No special weight should be given to the presence or absence of any particular factor.

Example 1-1: Application of the anti-abuse regulations.

Kevin, Bill, and John, all brothers, form the Bigmouth Partnership to operate a restaurant. Kevin, Bill, and John each contribute 1/3 of the partnership's capital. John has had some serious financial problems and has $500,000 of net operating losses that are about to expire. The partnership agreement provides that all partners are to receive a $35,000 guaranteed payment, and that John is to then receive 80% of the net income or loss for managing the restaurant, with Kevin and Bill each receiving 10%. The goal is to make the business profitable, then sell to BigBun, a national chain. The profits on the sale will be split equally.

While the allocations meet the literal test of IRC Sec. 704, they may be challenged by the IRS. First, the parties are related. Furthermore, even though the allocation meets the literal test of the statute, most of the income is allocated to John, who is effectively exempt from tax by virtue of the large NOL. This substantially reduces the present value of the taxes due from what it would be if the profits were allocated equally. Finally, the stated goal is to eventually sell the restaurant, at which time all of the parties will share the profit equally.

The IRS, by invoking the anti-abuse regulations, could reallocate the income to the partners; treat John as an employee (or independent contractor) rather than a partner; or terminate the partnership and treat the business as individual proprietorships.

In a controversial move, the IRS gave its agents blanket authority to apply the anti-abuse regulations in several areas without consulting the National Office. The areas involve several identified tax shelter items (e.g., Son of Boss and abusive Section 754 elections) as well as some new items that the IRS considers abusive. These new items include—

a. Use of a partnership or LLC to facilitate the sale of state tax credits.

b. Compensatory options sold to related parties.

c. Deals involving foreign corporations creating U.S. deductions where interest payments are limited under IRC Sec. 163(j).

The issuance of this blanket authority seems to be another indication of the aggressiveness with which the IRS is now approaching any alleged tax abuse. Avoiding the imposition of the anti-abuse rule involves careful documentation of the partnership's business purpose, as well as adherence to good business practices, particularly in closely held partnerships. Any special allocations should be structured so that tax consequences follow the economic benefits or burdens. Arrangements involving step transactions should be avoided. Deviations from good business practices are likely to result in the IRS reclassifying the transaction as abusive.

Knowing the Difference between Tax and Economic Allocations

The biggest source of confusion in the allocation area is the failure to recognize that each transaction has separate economic and tax components. This confusion is frequently caused by the fact that in many transactions the

economic and tax results are identical in all respects, making it hard to distinguish between the two. For example, if a partnership spends $10 in cash for a deductible item, the economic result is a $10 loss and the parallel tax result is also a $10 loss. The partner allocated the $10 economic loss must also be allocated the $10 tax loss. The fact that the economic and tax treatments are identical causes their separateness to be overlooked. This oversight often results in the allocation of tax results (usually tax losses) without consideration of the underlying economic allocation. (See Example 2-5.)

In analyzing a partnership agreement for the underlying economic arrangement of the partners, the practitioner must consider the agreement as a whole, not just the profit and loss allocations. Almost invariably, agreements that have suspect tax allocations attempt to treat an item of income or loss in one section of the document in a manner that is inconsistent with the treatment of that same item elsewhere in the agreement. For example, a loss allocated under the profit and loss provisions of the agreement may not have any effect on the liquidating distributions (typically covered in another section of the agreement) that the partners receive upon a partnership termination. An agreement may, for tax purposes, allocate losses to one partner, while providing that distributions (including liquidating distributions) are to be shared equally. This is a classic example of an allocation that does not have economic effect. In such situations, a question may arise over which section of the partnership agreement controls. If a partner is allocated a tax loss, but the allocation does not affect his or her distribution rights, which of the provisions controls, the tax loss allocation provision or the distribution provision?

Generally, the contribution and distribution provisions of an agreement are deemed to control the profit and loss allocation provisions. So, in the preceding case, the tax loss allocation should be coordinated with the distribution provision, and not the other way around. This determination of which section of the partnership agreement controls, however, is a matter of local law and the partners' agreement. Practitioners are cautioned against adopting interpretations of the agreement for tax purposes that may be inconsistent with the real economic agreement of the partners.

THE PARTNERSHIP AGREEMENT AND ITS EFFECT ON ALLOCATIONS

Addressing Allocations of Tax Results

Generally, partnerships have a written partnership agreement that sets out the partners' duties and the allocation to those partners of the partnership's tax and economic items. IRC Sec. 704(a) provides that this agreement governs the allocation of taxable income, gain, loss, deduction, and credit among the partners. By appearing to imply that partners have the ability to allocate tax results, IRC Sec. 704(a) creates a trap for the uninitiated because it seems to give the partners greater power to govern the allocation of partnership tax items than they actually have. In reality, tax allocations cannot be made independently of the corresponding economic results, and, in fact, merely follow the related economic allocations made under the partnership agreement. In the event that the partnership agreement's tax allocations do not have substantial economic effect, or if the agreement is silent concerning tax allocations, then the tax allocations must be in accordance with the partners' interests in the partnership.

Addressing Allocations of Economic Results

IRC Sec. 704 governs only the allocation of tax items and not the allocation of economic items. The tax laws cannot govern how partners agree to divide the partnership's economic results. Therefore, the partnership agreement is the final word on the allocation of economic items among the partners.

When reviewing a partnership agreement to determine the economic arrangement between the partners, it is important to look at all sections that impact the actual dollars to be contributed by or distributed to the partners. Special attention should be given to sections of the agreement dealing with:

a. capital contributions,

b. capital calls,

c. distributions of cash from operations,

d. requirements for funding deficits,

e. responsibility for partnership liabilities, and

f. liquidation provisions.

What Constitutes the Partnership Agreement?

For purposes of the substantial economic effect test, the term *partnership agreement* is broadly defined. In addition to the actual document itself, the regulations provide that the partnership agreement also includes all oral and written agreements among the partners, or between one or more partners and the partnership, concerning the partnership's affairs. This can be seen in Ltr. Rul. 9622014 where a withdrawing partner was not released from her personal guaranty by a lender, but the purchasing partner entered into a hold harmless agreement with the taxpayer. The IRS took this agreement between the two individuals into account in determining if the taxpayer constructively received a cash distribution. Also, the agreement includes federal, state, and local law governing the partnership's affairs. In determining proper tax allocations, this latter point is especially important with regard to legal requirements for partners to make contributions to a partnership to cover partnership losses or the rights of partners to share in partnership profits and distributions.

The IRS Partnership Audit Technique Guide points out that any document or oral agreement which bears on the underlying economic arrangement of the partners is considered to be part of the partnership agreement. Examples of such documents include loan and credit agreements; assumption agreements; indemnification agreements; subordination agreements; and correspondence with a lender concerning terms of a loan or guarantees.

Oral Modifications to Partnership Agreements

Occasionally, partners decide orally to change the partnership's method of making allocations. Reg. 1.704-1(b)(2)(ii)(h) provides that such oral modifications are allowed. However, the modifications must be binding and made in accordance with the terms of the partnership agreement or applicable state law. The IRS will respect the modified method only if proof of the oral modification can be produced, and the modification is made according to the provisions of the partnership agreement or state law. For LLCs formed in some states, an oral modification is impossible because the state LLC Act requires an LLC's operating agreement or amendments to the operating agreement be in writing. (However, an oral agreement may be equitably enforced by the court in those states or may be enforced as a contract executed by and among the members outside of the operating agreement.) When this is not the case, however, oral modifications may be valid if each member agrees to the modification. (However, the IRS can still argue the modification is invalid since it is not written.)

Where an oral modification has been made during the year, the practitioner should recommend that the modification be reduced to writing and signed by all partners. Even where the state statute permits an oral modification, the documentation of the partners' agreement is advisable for both legal and tax purposes. When memorializing an oral agreement, the practitioner should be careful not to backdate any documents. The proper way to memorialize an oral agreement is to prepare a document that includes (a) the date or approximate date (if the exact date cannot be verified) that the agreement was reached, (b) the effective date of the agreement, (c) the terms of the agreement that were reached, and (d) the date the written agreement was actually signed (in no case should this be backdated to the date the oral agreement was reached). All parties to the oral agreement should sign the written agreement.

Example 1-2: Oral modification of partnership agreement.

Bill Blast is a CPA engaged by the Rockyroad Partnership to prepare its 2010 tax return. The Rockyroad partnership agreement has a "boilerplate" provision that requires use of the safe harbor allocation method to make allocations. The agreement further provides that amendments to the agreement require the written consent of all partners. Sandy Hill, a partner of Rockyroad, has verbally indicated to Blast that the partners have agreed for 2010 and thereafter to make allocations based on the partners' interests in the partnership. Since the partnership agreement provides a specific method of allocation, and also contains a procedure requiring written amendments, Hill's directive to change this method of allocation is probably not a valid oral modification of the agreement, and would be disregarded by the IRS. Blast should tell Hill that the modification should be put into writing.

The proposed modification would be binding if all the partners signed an amendment to the agreement changing the method of allocation. However, since the safe harbor method and the partners' interest in the

partnership do not necessarily produce the same results, Blast should recommend that the partnership disclose to each partner what impact the modification would have. Blast should also recommend that the partners reduce their understanding to a written agreement or memorandum.

Making Changes to the Partnership Agreement after Year-end

Modifications to a partnership agreement that affect a specific partnership year can be made up to the due date (not including extensions) of that year's partnership tax return—April 15th for a calendar-year partnership. In effect, this means the partnership's tax allocation provisions can be manipulated to conform to the partner's year-end tax planning needs; however, there cannot be retroactive allocations. To be allowable, the special allocations must also comply with the substantial economic effect rules. In the case of a family partnership, the special family partnership rules in IRC Sec. 704(e) must be met as well.

Reviewing the Tax Return

A partnership return must be prepared in a way that ensures the tax allocations will be respected. This requires a careful review of the governing documents and the partnership statute (if default provisions in the law apply). If the governing documents provide for tax allocations that are not valid under the rules, the practitioner must reallocate partnership items to reflect the partners' interests in the partnership. The practitioner should also notify the client of the problem, preferably in writing, and the documents should be amended to correct the problem. In addition, the partners should be notified that the Schedule K-1 allocations were not made in accordance with the partnership agreement's provisions. This notification might be accomplished by a statement in the Schedule K-1 cover letter.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. For the Goldmine Partnership's tax allocations to be viable under IRC Sec. 704, which of the following must be true?

   a. Tax allocations to the partners are made consistently with allocations of the corresponding economic items.

   b. All tax allocations within the partnership must have been made according to the safe harbor provisions.

   c. All tax allocations must be made equally between the partners (e.g., if there are two partners, the allocations must be 50/50).

   d. Partnerships are granted great latitude in making allocations, so there are no specific tests that must be met to ensure that they are valid.

2. The Foreman Partnership must allocate income from a related-party transaction. What Code section(s) must be consulted to determine the proper tax treatment?

   a. IRC Sec. 704 only.

   b. IRC Secs. 83 and 704.

   c. IRC Secs. 482 and 704.

   d. IRC Secs. 704, 707(a), and 1001.

3. Which of the following partnerships may pass the economic substance tests found in Subchapter K of the Internal Revenue Code?

   a. Upon close inspection, the Alpha Partnership is not a bona fide entity.

   b. Beta Partnership's partnership agreement calls for an equal split of economic items, but all tax losses are allocated to a single partner.

   c. Transactions made by the Gamma Partnership are made for business purposes that are identified as both bona fide and substantial.

4. What has the final authority on how a partnership allocates its economic items?

   a. The partnership's tax allocations.

   b. IRC Sec. 704.

   c. The partnership agreement.

5. The Silver Lake Partnership is a calendar-year partnership. The partners would like to modify the partnership agreement for the 2010 tax year. The partnership agreement can be modified until what date?

   a. January 1, 2010.

   b. December 31, 2010.

   c. April 15, 2011.

   d. December 31, 2011.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. For the Goldmine Partnership's tax allocations to be viable under IRC Sec. 704, which of the following must be true? **(Page 89)**

   a. Tax allocations to the partners are made consistently with allocations of the corresponding economic items. [This answer is correct. According to IRC Sec. 704, generally, partners cannot allocate tax items in a manner inconsistent with allocations of the corresponding economic items. This ensures that if a partner reaps the economic benefit of an income or gain allocation, that same partner is allocated the income or gain for tax purposes. The Code offers two specific tests for validating tax allocations.]

   b. All tax allocations within the partnership must have been made according to the safe harbor provisions. [This answer is incorrect. The safe harbor rules contain capital account maintenance rules that attempt to establish uniform bookkeeping procedures for the economic (not tax) results of partnership operations. Once the economic bookkeeping is done properly, the allocation of tax results among the partners must be made in a manner consistent with the allocation of the corresponding economic results.]

   c. All tax allocations must be made equally between the partners (e.g., if there are two partners, the allocations must be 50/50). [This answer is incorrect. If the partnership agreement stipulates that one of the two partners has a 25% interest in the Goldmine Partnership while the other partner has a 75% interest, the allocations could reflect those interests—IRC Sec. 704 would not force the allocations to be made 50/50.]

   d. Partnerships are granted great latitude in making allocations, so there are no specific tests that must be met to ensure that they are valid. [This answer is incorrect. Historically, partnerships were granted considerable latitude in allocating income, gain, losses, deductions, and credits among their partners for tax purposes. However, Congress, the courts, and the IRS have clarified and increased restrictions on partnership tax allocations. Now, under IRC Sec. 704, two avenues exist for testing the viability of the tax allocations in partnerships such as the Goldmine Partnership.]

2. The Foreman Partnership must allocate income from a related-party transaction. What Code section(s) must be consulted to determine the proper tax treatment? **(Page 90)**

   a. IRC Sec. 704 only. [This answer is incorrect. IRC Sec. 704 is not the exclusive test for determining the validity and tax consequences of a tax allocation. Other tax principles also must be considered.]

   b. IRC Secs. 83 and 704. [This answer is incorrect. While IRC Sec. 704 should be considered, IRC Sec. 83, which covers employee compensation, would not be applicable in the scenario above.]

   c. IRC Secs. 482 and 704. [This answer is correct. While an allocation may satisfy the Section 704(b) rules, other Code sections (such as, in this scenario, IRC Sec. 482 which covers the allocation of income between related parties) may still affect the tax treatment of that allocation. In this scenario, the partnership should consult both IRC Secs. 482 and 704.]

   d. IRC Secs. 704, 707(a), and 1001. [This answer is incorrect. While IRC Sec. 704 should be considered, IRC Secs. 707(a) and 1001 deal with sales, and, so, would not be consulted for the scenario described above.]

3. Which of the following partnerships may pass the economic substance tests found in Subchapter K of the Internal Revenue Code? **(Page 90)**

   a. Upon close inspection, the Alpha Partnership is not a bona fide entity. [This answer is incorrect. One of the five tests found in Subchapter K is that the entity must be bona fide. Because it failed this test, the IRS would not have to respect this entity as a partnership.]

   b. Beta Partnership's partnership agreement calls for an equal split of economic items, but all tax losses are allocated to a single partner. [This answer is incorrect. Subchapter K includes five tests that must be met. Beta Partnership fails to meet one of these tests because the tax consequences of the transactions in question do not accurately reflect the partners' economic agreement. The IRS can disregard these transactions or otherwise modify, ignore, or change them to reflect "reality."]

   c. Transactions made by the Gamma Partnership are made for business purposes that are identified as both bona fide and substantial. [This answer is correct. One of the five tests set forth in Subchapter K is that each transaction must have a bona fide and substantial business purpose. Delta Partnership passes this test. Assuming all other Subchapter K tests were met, Delta Partnership and its transactions would not be disregarded by the IRS.]

4. What has the final authority on how a partnership allocates its economic items? **(Page 92)**

   a. The partnership's tax allocations. [This answer is incorrect. Per the Internal Revenue Code, tax allocations cannot be made independently of the corresponding economic results, and, in fact, merely follow the related economic allocations.]

   b. IRC Sec. 704. [This answer is incorrect. IRC Sec. 704 governs only the allocation of tax items and not the allocation of economic items.]

   c. The partnership agreement. [This answer is correct. Generally, partnerships have a written partnership agreement that sets out the partners' duties and the allocation to those partners of the partnership's tax and economic items. Tax laws cannot govern how partners agree to divide the partnership's economic results. Therefore, the partnership agreement is the final word on the allocation of economic items among the partners.]

5. The Silver Lake Partnership is a calendar-year partnership. The partners would like to modify the partnership agreement for the 2010 tax year. The partnership agreement can be modified until what date? **(Page 94)**

   a. January 1, 2010. [This answer is incorrect. According to the Internal Revenue Code, a partnership does not have to have such modifications in place as of the beginning of the tax year. Therefore, the Silver Lake Partnership has more time to make such modifications.]

   b. December 31, 2010. [This answer is incorrect. Under the Internal Revenue Code, the end of the tax year is not the deadline for such modifications.]

   c. April 15, 2011. [This answer is correct. Under the Code, modifications to a partnership agreement that affect a specific partnership year can be made up to the due date (not including extensions) of that year's partnership return—April 15 for a calendar-year partnership. In effect, this means the partnership's tax allocation provisions can be manipulated to conform to the partners' year-end tax planning needs.]

   d. December 31, 2011. [This answer is incorrect. Under the Code, retroactive allocations are not allowed for this type of special allocation. The Silver Lake Partnership would have to have the modification in place before this date, despite any tax considerations that might come up in future tax years.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TPSTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. At what level are partnerships taxed?

   a. At the partnership level.

   b. At the partner level.

   c. Taxes are incurred at both the partnership and the partner level.

   d. Partnerships are tax-exempt.

2. List all of the following ways that a partnership's tax allocations can be tested for validity under IRC Sec. 704.

   i. Determining if the allocation was made in accordance with the partner's interest in the partnership.
   ii. Determining that all tax allocations have a corresponding economic element.
   iii. Determining that the allocation would be classified as having substantial economic effect under the safe harbor provisions.

   a. i. only.

   b. i. and ii.

   c. i. and iii.

   d. i., ii., and iii.

3. When drafting its partnership agreement, how should a partnership address economic and tax allocations?

   a. They should be recognized as separate transaction components.

   b. They should be considered a single component as the results are usually identical.

   c. They can be treated differently by different parts of the agreement.

   d. They must be treated as spelled out in the safe harbor rules.

4. Joe and Jane are forming a partnership. According to the regulations, which of the following items must be included in their partnership agreement?

   a. Only the actual document that delineates their duties and the allocation of tax and economic items.

   b. The document plus any written agreements concerning partnership affairs.

   c. The document plus any written or oral agreements concerning partnership affairs.

   d. The document, any written or oral agreements about partnership affairs, and federal, state, or local laws governing partnership affairs.

5. The Casual Partnership is formed on January 1, 2009. Its partnership agreement specifies that allocations will be made based on the partner's interest in the partnership. On December 15, 2009, the partners make an oral agreement, effective January 1, 2010, to switch to the safe harbor allocation for 2010 and all years thereafter. State law permits oral agreements. On June 15, 2010, the partnership's accountant recommends that the partners memorialize the oral agreement with a written document so there is proof of the agreement in case the IRS questions certain transactions. The written document is drafted and signed by the partners on August 3, 2010. What date should the partnership use for the date of the written document?

   a. December 15, 2009.

   b. January 1, 2010.

   c. June 15, 2010.

   d. August 3, 2010.

Lesson 2: Substantial Economic Effect and the Safe Harbor Rules

INTRODUCTION

The Ability to Make Special Tax Allocations

A special tax allocation is an allocation of income, gain, loss, deduction, or credit among the partners that is not in proportion with their ownership interest. For example, the allocation of 90% of tax losses to a 50% partner is a special tax allocation.

A partnership's special tax allocation arrangement is often structured so that during the early years in which tax losses are expected, the losses are specially allocated to partners who can best use the deductions (typically the "money" partners who are essentially investors). The other partners, who are not as interested in tax deductions, are allocated a disproportionately small amount of the losses. Later, when the partnership generates taxable income or gains, they are specifically allocated to the "money" partners to offset the earlier disproportionate allocation of losses.

If the partnership's financial projections succeed, the cumulative allocations of income and losses will be proportionate to the stated ownership interest percentages.

The IRS has set forth complicated rules (the substantial economic effect rules) to ensure that special partnership tax allocations are not made in an artificial or abusive manner. The basic concept is that the partners cannot be allocated tax losses or deductions unless they are also allocated the related economic losses (or will eventually be allocated offsetting taxable income). Neither can partners be allocated taxable income or gain unless they are also allocated the related economic income (or will eventually be allocated offsetting tax losses). Essentially, these rules require the following:

- Partner capital accounts must reflect the allocations of taxable income, gain, loss, and deduction.
- Upon liquidation, the partnership must pay partners (or collect money from partners) according to their respective positive or negative capital accounts.

The substantial economic effect regulations have the consequence of assuring that a partner who receives a special allocation, for example, of extra depreciation or additional tax losses will ultimately incur an economic cost for that write-off. Any special tax allocation of deductions to a partner must be charged to the partner's capital account, and the partner's capital account must be used as a measure of the partner's respective share of the partnership in the event of dissolution. Thus, the extra tax return deductions allocated to the partner will ultimately reduce the partner's eventual claim to the assets of the partnership. If the partner has a negative capital account at the liquidation of the partnership interest, there must be a requirement that any deficit balance in the capital account be restored by the partner.

Learning Objectives:

Completion of this lesson will enable you to:
- Compare and contrast the safe harbor rules and allocations made according to partnership interests.
- Identify allocations that have economic effect and those that have a substantial effect.
- Summarize the rules for maintaining book capital accounts under the safe harbor rules.

THE SUBSTANTIAL ECONOMIC EFFECT SAFE HARBOR RULES

The substantial economic effect rules provide a safe harbor for making tax allocations. While the basic rule requiring that tax allocations be made in accordance with the partners' interests in the partnership is broad and general, the substantial economic effect regulations provide detailed and complex rules and instructions. Practi-

tioners frequently do not understand that valid allocations can be made under either set of rules. It is not necessary that the tax allocations have substantial economic effect; it is only necessary that the tax allocations be in accordance with the partners' interests in the partnership. The substantial economic effect rules are only a safe harbor. The purpose of the substantial economic effect safe harbor rules is to provide a uniform system of bookkeeping for the economic results of partnership operations. Once the economic bookkeeping has been done to accurately reflect the partners' real economic agreement, the tax allocations must be made in a manner consistent with the way the economic results of operations have been allocated among the partners.

The economic accounting rules of the safe harbor provision are special rules that exist for tax accounting purposes and are not fully consistent with generally accepted accounting principles (GAAP). Although GAAP and the safe harbor rules have much in common, there are some fundamental differences arising from the job each is designed to perform. While GAAP is concerned with presenting a fair financial picture of a business over time, economic accounting under the safe harbor rules is not concerned with time or the financial health of a business. Instead, the safe harbor accounting rules deal with the relative rights of the partners in the liquidation value of a partnership.

Applying Both Parts of the Two-part Test

The safe harbor substantial economic effect test has two components; an allocation must comply with both to fall within the safe harbor.

a. The economic allocations must have economic effect, and the tax allocations corresponding to the economic allocations must be made in the manner that is most consistent with the economic allocations.

b. Both the tax and economic allocations must be substantial.

The substantial economic effect regulations are complicated, confusing, and do a poor job of differentiating between tax and economic allocations, frequently making it difficult to understand which is being discussed. In reading the regulations, practitioners should remember that the capital accounts under discussion are economic capital accounts and not tax-basis capital accounts. It also helps to remember that the capital account maintenance portion of the regulations is really nothing more than an attempt to establish uniform bookkeeping rules for partnership operations so that stated economic allocations reflect the partners' real economic agreement. The tax allocations are then made in a manner consistent with how the economic results of operations are allocated among partners. (See Example 2-5.)

Example 2-1: Making special allocations that comply with the economic effect rules.

Phil and Charlie form a general partnership with each partner contributing $1,000 cash. The partnership purchases depreciable property for $5,000 using the $2,000 cash and borrowing $3,000 on a recourse loan for which the partners are both liable. Assume the property is depreciated using the straight-line method over five years for both tax and economic (book) purposes. The partnership leases the property to a third party. During Year One, the partnership's rental income equals its operating expenses, and the partnership has a net loss of $1,000 arising from depreciation.

Phil needs tax losses. Therefore, the partners specify in the partnership agreement that all losses will be allocated 100% to Phil, and all profits will be allocated first to chargeback for the specially allocated losses. Thereafter, profits will be split equally. The agreement also adopts the safe harbor capital account provisions. [Book capital accounts will be maintained under Reg. 1.704-1(b)(2)(iv). All allocations will be reflected in the partners' book capital accounts. The partnership will be liquidated by book capital accounts, and partners with negative book capital accounts on liquidation will restore the deficit within the required time period.]

The agreement meets the safe harbor economic effect requirements, since the rules for book capital account maintenance, liquidation by book capital accounts, and contributions to restore negative book capital accounts are met. Therefore, the desired economic allocations are allowable, even though (a) they may have been done with tax motives, (b) the property may not, in fact, depreciate economically, and (c) the losses are allocated in a manner that is different than the overall economic agreement (real profits are split 50/50). The corresponding tax losses are allocated between the partners in the manner most consistent with the book allocations, as follows:

	Phil		Charlie		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 2,000	$ 2,000
Year One loss	(1,000)	(1,000)	—	—	(1,000)	(1,000)
Ending capital	$ -0-	$ -0-	$ 1,000	$ 1,000	$ 1,000	$ 1,000

In this case, the partners' desired tax allocations are allowed under the substantial economic effect safe harbor because the partners are willing to live with the corresponding economic implications (Phil bears the burden for 100% of the book losses since the loss allocations have actually affected the dollar amount he receives on liquidation).

MAKING ALLOCATIONS ACCORDING TO PARTNERS' INTERESTS IN THE PARTNERSHIP

Because many partnerships do not fully comply with all of the specific, detailed capital account maintenance provisions of the substantial economic effect safe harbor regulations, it is important to recognize that the partners' interests in the partnership rule for allocations provides broad-based alternatives to the safe harbor substantial economic effect rules. In fact, most partnerships need to rely on a partners' interests in the partnership argument if their tax allocations are challenged by the IRS.

For the most part, the rules for determining a partner's interest in the partnership and for determining whether a tax allocation has substantial economic effect are similar. The detailed guidelines in the safe harbor regulations for determining substantial economic effect can also be looked to for guidance in determining the partners' interests in the partnership. The purpose of both tests is to ensure each tax allocation matches the partners' agreed allocations of the corresponding economic results according to their economic agreement. (See Examples 2-2 and 2-3.)

The difference between the two tests is that, where the partners' interests in the partnership rules constitute broad and general rules for making tax allocations, the substantial economic effect rules give detailed (and lengthy) guidance on how partners must perform their economic—not tax—accounting. Under the substantial economic effect rules, if the partnership follows the economic accounting guidelines established by the regulations and allocates the tax results to match, the tax allocations will be allowed without further question. The Code and regulations, however, recognize that Congress and Treasury cannot always anticipate or control the economic agreements among partners or the accounting therefore; the partners' interests in the partnership rule is required as well.

Because the number of potential economic agreements among partners is infinite, the partners' interests in the partnership regulations are very broad and simple. At least they are simple to state; they can be quite difficult to apply because, by design, they are only general guidelines. The basic rule is simply that tax allocations must be made to reflect the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the taxable income, gain, loss, deduction, or credit that is allocated.

The analysis of a partner's interest in the partnership is probably best done using a capital account approach similar to that used under the substantial economic effect safe harbor rules. (See Example 2-4.)

It is important to emphasize that the partners' interests in the partnership rules are not an invitation to distort partnership allocations. While detailed guidance is by necessity lacking, it is probably fair to say that the IRS and courts will closely scrutinize economic allocations that do not at least attempt to parallel the substantial economic effect safe harbor rules, and tax allocations that do not match the corresponding economic allocations in the closest possible manner.

Determining Partners' Interests in the Partnership

Under the partners' interests in the partnership rules, the economic sharing arrangement among the partners is determined on an item-by-item basis, taking into account all facts and circumstances. All partners' interests are

initially presumed to be equal, but this presumption can be overcome by either the IRS or the taxpayer based on facts and circumstances (including, of course, the partnership agreement).

Four (nonexclusive) factors are listed in the regulations as being considered in determining the partners' interests in the partnership (PIP):

a. The partners' relative contributions to the partnership.

b. The interests of the partners in economic profits and losses.

c. The interests of the partners in cash flow and other nonliquidating distributions.

d. The rights of the partners to distributions of capital upon liquidation.

In a real-life illustration of how the PIP principle is applied, consider the case of two brothers who were partners in a farming partnership. One brother contributed approximately $1 million to the partnership, while the other contributed only $2,320. There was no written partnership agreement. However, evidence indicated the brothers intended to share profits equally after recovering their respective capital contributions. The brothers had a falling out, and the brother who had contributed the $1 million then filed partnership returns showing a 50/50 split of taxable income. Upon audit, the IRS reallocated all income to the brother who had contributed the $1 million. The Tax Court agreed with the IRS by finding that allocating 100% of the income to that brother was in accordance with the PIP because that brother received the economic benefit of 100% of the income realized by the partnership. In coming to this conclusion, the Tax Court used the PIP capital account analysis approach explained in this course.

The safe harbor rule creates a high possibility for distorting the real economic arrangement between partners, especially if contributed property has been held for a significant period of time prior to contribution and, consequently, has a relatively short tax life remaining. In the following example, the safe harbor mandated economic life for the original portion of the hotel would be five years, even though the economic life of the property, as reasonably determined and agreed by the partners, is 39 years.

Example 2-2: Dealing with safe harbor allocations of depreciation expense.

Bill has owned a hotel for a number of years. The hotel's current value is $19.5 million, its tax basis is only $2.5 million (it is on leased land, so none of the basis is allocable to land). The hotel's remaining depreciable life is five years, and it is currently depreciated using the straight-line method. Sara agrees to contribute $19.5 million cash to a general partnership for remodeling the hotel and Bill is to contribute the hotel. The partnership agreement provides that Sara will be specially allocated all of the depreciation for the first five years, Bill will be allocated all of the depreciation for the next 10 years, and thereafter all depreciation will be split equally. Operating profits and losses will be shared equally. Gain on sale will be allocated first to charge back depreciation losses and then shared equally. The partners must comply with the safe harbor regulations except for the depreciation allocation, and to use the traditional method for making allocations under IRC Sec. 704(c).

The remodeling is completed using all of Sara's contributed capital. The depreciation on the remodeled portion is $500,000 per year (straight-line over 39 years). The partners estimate that the economic life of the remodeled hotel is 39 years, which is also the remaining period on the land lease.

If the partners adopt the safe harbor rules for maintaining capital accounts, over the first five years, the book depreciation on the original portion of the hotel will be $3.9 million per year ($19.5 million over five years), while the annual tax depreciation will be $500,000. The annual book and tax depreciation for the remodeled portion of the hotel will be $500,000. Thus, the book and tax accounts of the partners at the end of the fifteenth year would be as follows (in thousands):

	Bill		Sara		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 19,500	$ 2,500	$ 19,500	$ 19,500	$ 39,000	$ 22,000
Depreciation						
Year One	—	—	(4,400)	(1,000)	(4,400)	(1,000)
Years Two–Five	—	—	(17,600)	(4,000)	(17,600)	(4,000)
Year Six	(500)	(500)	—	—	(500)	(500)
Years Seven–15	(4,500)	(4,500)	—	—	(4,500)	(4,500)
End Year 15	$ 14,500	$ (2,500)	$ (2,500)	$ 14,500	$ 12,000	$ 12,000

The partners' book capital accounts started out equal. The project's real economic decline is at a steady rate over 39 years. And although Bill has been allocated 100% of the economic depreciation for a period twice as long as Sara, and has received the same total tax depreciation allocation, he has a significant ending positive book capital account while Sara's is negative. If the partnership were to liquidate at the end of the fifteenth year, and all of the partnership assets were sold for their then safe harbor book value, Bill would get everything and Sara owes him another $2.5 million to boot. That result simply does not make sense.

The tremendous book losses recognized by Sara occur because of the safe harbor book depreciation same period, same method as tax requirement, which results in the original portion of the property being fully depreciated over five years for economic purposes. While the deal requires that Sara take all depreciation risks for the first five years, the required safe harbor economic depreciation is not realistic and forces Sara to take economic risks that are way out of proportion to economic reality.

So, what choices did the partners in the preceding example have? First, they could elect not to specially allocate the depreciation during the first five years, but that is not an acceptable approach because it forces them to change their economic agreement (and yes, the tax depreciation allocations also change during that period). The tax regulations should not force the partners into unwanted arrangements.

Example 2-3: Using nonsafe harbor methods when allocating depreciation expense.

Assume the same facts as in Example 2-2. This time the partners decide not to follow the safe harbor rules for the economic depreciation of the preexisting portion of the hotel. Instead of using the same period, same method as tax approach for determining the economic depreciation of the original portion, the partners adopted for book purposes a 39-year useful life, using the straight-line method.

Assume for our purposes that such a useful life and depreciation method is a fully supportable, reasonable economic position. In that case, the economic depreciation for the original portion of the hotel would be $500,000 per year, instead of the $3.9 million required by the safe harbor rules (and the book and tax depreciation for the remodeling expenditures each remain at $500,000 per year). Now, allocating Sara 100% of the economic depreciation in each of the first five years results in $1 million per year of book depreciation being allocated to her, instead of the $4.4 million per year that is required by the safe harbor regulations. Since that economic allocation clearly conforms with reality, there seems no question that it would be consistent with Sara's economic interest in the partnership.

The safe harbor rules would require allocation to Sara of tax depreciation equal to her book depreciation (subject to the ceiling rule), and allocation of the balance of the tax depreciation, if any, to Bill. There certainly may be other ways to allocate the tax depreciation, but there is every reason to believe that this approach is proper. This approach results in the following allocations of book and tax depreciation over a 15-year period (in thousands):

	Bill		Sara		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 19,500	$ 2,500	$ 19,500	$ 19,500	$ 39,000	$ 22,000
Depreciation						
Year One	—	—	(1,000)	(1,000)	(1,000)	(1,000)
Years Two–Five	—	—	(4,000)	(4,000)	(4,000)	(4,000)
Year Six	(1,000)	(500)	—	—	(1,000)	(500)
Years Seven–15	(9,000)	(4,500)	—	—	(9,000)	(4,500)
End Year 15	$ 9,500	$ (2,500)	$ 14,500	$ 14,500	$ 24,000	$ 12,000

The preceding results are clearly more in line with the economic agreement between the partners than are the results under the safe harbor regulations. At the end of the 15th year, Bill's book capital account reflects the fact that he has received twice the economic loss allocations that Sara has, which is consistent with their agreed upon economic arrangement.

The allocation of partnership items to Bill and Sara under the safe harbor rules distorts the partners' capital account balances and does not accurately reflect the economic arrangement between the partners. A much more reasonable approach is achieved by allocating depreciation deductions based on the partners' interests in the partnership rules. While there is little guidance on how to apply the partners' interests in the partnership rules to partnership allocations, it seems clear that in this fact situation the allocations proposed by Bill and Sara would be respected since they accurately reflect the economic interests of the partners in the partnership.

Understanding Problems with Safe Harbor Depreciation Allocations

Some states generally adopt the federal tax rules, including the Section 704(b) regulations, for determining state tax but retain a number of specific differences. When one of those differences is the amount of depreciation allowable for a specific asset in any year, it is literally impossible to meet the safe harbor rules for both federal and state tax purposes, because to do so would require different book capital accounts to be used for federal and state purposes. That, of course, is not possible. The capital account is the measure of the economic liquidation rights of the partner, and, obviously, a partner can have only one liquidation right. Thus, in such a case, the economic allocations need to be analyzed under the partners' interest in the partnership rules for either federal or state tax purposes (or both).

Given this problem, how should the tax depreciation be allocated to conform with the partners' interests in the partnership rules? There is virtually no direct authority on how to resolve this issue in the regulations or elsewhere. However, it certainly seems reasonable to take the same approach that is used under the safe harbor rules.

Example 2-4: Using a property-by-property approach under the safe harbor regulations to allocate depreciation expense to multiple properties.

In the table in the preceding example, the economic depreciation beginning with Year Six is double the tax depreciation. Actually, there are two properties being depreciated, the original hotel and the remodeling expenditures. The economic depreciation of the original hotel (Property One) beginning with Year Six is $500,000 per year, while the tax depreciation is zero. For the remodeled portion (Property Two), the book and tax depreciation amounts are both $500,000 per year.

Assume the same basic facts as in Example 2-2 except the partnership agreement calls for the economic depreciation to be split equally between Bill and Sara from the beginning of the partnership. The safe harbor regulations adopt a property-by-property approach where there are multiple properties. Fundamental to the capital account concept is that tax depreciation follows economic depreciation. (See Example 2-5.) This fundamental rule applies in the preceding examples. In the first five years everything seems to be going as one would expect; unfortunately, beginning with the sixth year, the fundamental rule creates some real problems, as the following table illustrates (in thousands):

	Bill		Sara		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 19,500	$ 2,500	$ 19,500	$ 19,500	$ 39,000	$ 22,000
Depreciation						
Year One						
Property One	(250)	(250)	(250)	(250)	(500)	(500)
Property Two	(250)	(250)	(250)	(250)	(500)	(500)
Years Two–Five						
Property One	(1,000)	(1,000)	(1,000)	(1,000)	(2,000)	(2,000)
Property Two	(1,000)	(1,000)	(1,000)	(1,000)	(2,000)	(2,000)
Year Six						
Property One	(250)	—	(250)	—	(500)	—
Property Two	(250)	(250)	(250)	(250)	(500)	(500)
Years Seven–15						
Property One	(2,250)	—	(2,250)	—	(4,500)	—
Property Two	(2,250)	(2,250)	(2,250)	(2,250)	(4,500)	(4,500)
End Year 15	$ 12,000	$ (2,500)	$ 12,000	$ 14,500	$ 24,000	$ 12,000

Bill is allocated his share of the economic and tax depreciation from Property Two; however, all the tax basis in Property Two is derived from contributions made by Sara. Bill will not be able to use the tax depreciation (beginning in Year Six) because of the limits of IRC Sec. 704(d) (which allows the deduction of partnership losses only to the extent of a partner's tax basis) unless he has partnership tax basis from other sources.

Applying the Ceiling Rule

The ceiling rule provides that the amount of revenue, gain, loss, and deduction that can be allocated to a partner for tax purposes cannot exceed 100% of the amount of such item that the partnership actually recognizes for tax purposes. The ceiling rule limits the tax allocations to Sara in the preceding examples. Because there is no tax depreciation associated with the economic depreciation for Property One, Sara cannot be allocated any tax depreciation for that property. This is true notwithstanding that she is suffering economic loss and notwithstanding that her original cash contribution did not have any book/tax difference. Additionally, for Property Two, there is no book/tax difference, and the tax losses must be allocated in the manner most consistent with the economic losses. Thus, Sara and Bill receive tax depreciation equal to economic depreciation for Property Two. (See Example 2-4.) Because of the ceiling rule and the basic book/tax matching rules, the tax losses relating to her contribution are being allocated to Bill, and Sara's book capital account is decreasing faster than her tax account, which is creating a book/tax difference for her.

The issues involving book/tax difference problems are virtually limitless, and it is only by working through the specific problems involved in the individual transactions that the practitioner will gain insight into the best approach for the specific problem at hand. There are no set answers, and little guidance is offered in the current regulations. The most important thing to keep in mind, however, is that the safe harbor rules are only the beginning of the analysis; and properly handled, many other approaches are possible. The practitioner need only realize that there are alternatives and be creative in finding solutions that make sense. If the partners can demonstrate clearly that there are economic reasons for their approach, that their economic assumptions are justifiable, that their approach in fact reflects their real economic arrangement, and that the tax allocations are made in the manner most consistent with the economic allocations, it is highly likely that the partners' approach will be approved.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. The Echo Partnership has four partners. Andy and Betty each have a 40% partnership interest, while Charlie and Dina each have a 10% interest. In the early years of the partnership, tax losses are all allocated to Andy. Partnership income will not be allocated to Andy and Betty until later in the life of the partnership. This is an example of what kind of allocation?

   a. An allocation based on the partners' interest in the partnership.

   b. A special tax allocation.

   c. The safe harbor rules.

7. Dean and Keith each contribute $2,000 to form the Mars Partnership. The Mars Partnership is a general partnership. It purchases depreciable property for $10,000 using the $4,000 of contributed cash and borrowing the rest through a recourse loan. Both Dean and Keith are liable for the recourse loan. The property is depreciated over five years for both tax and book purposes using the straight-line method. Because Dean needs tax losses, the partnership agreement specifies that all losses will be allocated 100% to Dean and that all profits will first be allocated to chargeback for the losses. After the chargeback, the profits will be split equally between Dean and Keith. Does the Mars Partnership qualify to use the safe harbor rules?

   a. Yes, if it meets certain requirements.

   b. No, it uses the partners' interest in the partnership method.

8. When comparing the safe harbor rules and the partnership interests rules, which of the following do the two sets of rules share?

   a. Purpose.

   b. Broad and general rules.

   c. Lengthy, detailed rules.

   d. Tax allocations that are not questioned by the IRS.

9. The Powerhouse Partnership relies on the safe harbor rules to perform its economic accounting. The partnership owns depreciable property. Assume that if the partnership accounts for the depreciation using the safe harbor rules, one partner will be forced to recognize economic risks that are out of proportion to economic reality. Which of the following would be the best option for the partners in this partnership?

   a. They must use the safe harbor rules regardless of the consequences.

   b. They should change their economic agreement.

   c. They should develop an allocation approach based on the partners' interests in the partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. The Echo Partnership has four partners. Andy and Betty each have a 40% partnership interest, while Charlie and Dina each have a 10% interest. In the early years of the partnership, tax losses are all allocated to Andy. Partnership income will not be allocated to Andy and Betty until later in the life of the partnership. This is an example of what kind of allocation? **(Page 101)**

   a. An allocation based on the partners' interests in the partnership. [This answer is incorrect. The allocations made by the Echo Partnership do not meet the Internal Revenue Code qualifications for being made in accordance with the partners' interests in the partnership.]

   b. A special tax allocation. [This answer is correct. According to the IRS, a special tax allocation is an allocation of income, gain, loss, deduction, or credit among the partners that is not in proportion with their ownership interest. The allocations made by the Echo Partnership in this scenario are an example of a special tax allocation.]

   c. The safe harbor rules. [This answer is incorrect. The IRS has set forth complicated rules (the substantial economic effect rules) to ensure that special partnership tax allocations are not made in an artificial or abusive manner. These rules provide a safe harbor for making tax allocations. While these rules might be used to account for the tax allocations made by the partnership, the rules do not mandate that the partnership make such a tax allocation. The safe harbor rules can be used to account for such an allocation after it has been made.]

7. Dean and Keith each contribute $2,000 to form the Mars Partnership. The Mars Partnership is a general partnership. It purchases depreciable property for $10,000 using the $4,000 of contributed cash and borrowing the rest through a recourse loan. Both Dean and Keith are liable for the recourse loan. The property is depreciated over five years for both tax and book purposes using the straight-line method. Because Dean needs tax losses, the partnership agreement specifies that all losses will be allocated 100% to Dean and that all profits will first be allocated to chargeback for the losses. After the chargeback, the profits will be split equally between Dean and Keith. Does the Mars Partnership qualify to use the safe harbor rules? **(Page 102)**

   a. Yes, if it meets certain requirements. [This answer is correct. With the following additions to the partnership agreement, the Mars Partnership will meet the safe harbor economic effect requirements, according to the IRS regulations. The partnership must maintain book capital accounts under Reg. 1.704-1(b)(2)(iv). All allocations must be reflected in the partners' book capital accounts. The partnership must be liquidated by book capital accounts, and partners with negative book capital accounts on liquidation must restore deficit within the required time period.]

   b. No, it uses the partners' interest in the partnership method. [This answer is incorrect. The special tax allocation described in the scenario above does not accurately reflect Dean and Keith's 50/50 interest in the Mars Partnership; therefore, the partnership cannot defend its tax allocations using this method if challenged by the IRS.]

8. When comparing the safe harbor rules and the partnership interests rules, which of the following do the two sets of rules share? **(Page 103)**

   a. Purpose. [This answer is correct. The purpose of both tests, as they are described in the IRS regulations, is to ensure each tax allocation matches the partners' agreed allocations of the corresponding economic results according to their economic agreement.]

   b. Broad and general rules. [This answer is incorrect. The partnership interest rules have broad and general rules for making tax allocations. The safe harbor rules are not considered broad and general.]

c. Lengthy, detailed rules. [This answer is incorrect. The substantial economic effect rules, as they exist within the IRS regulations, give detailed (and lengthy) guidance on how partners must perform their economic accounting. The partnership rules are not as detailed.]

d. Tax allocations that are not questioned by the IRS. [This answer is incorrect. Under the substantial economic effect rules, if the partnership follows the economic accounting guidelines established by the regulations and allocates the tax results to match, the tax allocations will be allowed without further question. Using the partners' interests in the partnership rules has no such guarantee.]

9. The Powerhouse Partnership relies on the safe harbor rules to perform its economic accounting. The partnership owns depreciable property. Assume that if the partnership accounts for the depreciation using the safe harbor rules, one partner will be forced to recognize economic risks that are out of proportion to economic reality. Which of the following would be the best option for the partners in this partnership? **(Page 104)**

a. They must use the safe harbor rules regardless of the consequences. [This answer is incorrect. Under certain circumstances, the safe harbor rules create a high possibility of distorting the real economic arrangement between partners. If that is the case, the partners are not required by the regulations to use this approach. The safe harbor rules are only the beginning of the analysis. Properly handled, many other approaches are possible.]

b. They should change their economic agreement. [This answer is incorrect. It is not appropriate for the tax regulations to force the partners into unwanted arrangements. The tax allocation rules of IRC Sec. 704 are designed to ensure that the allocation of tax results to the partners follows the allocation of economic results.]

c. They should develop an allocation approach based on the partners' interests in the partnership. [This answer is correct. If the partners choose alternative allocations that accurately reflect their economic interests in the partnership under the partners' interests in the partnership rules, it seems clear that this decision would be respected by the IRS.]

ALLOCATIONS WITH ECONOMIC EFFECT

General Rule

The first element of the substantial economic effect safe harbor rules is the concept of *economic effect*. For a tax allocation to have economic effect under the safe harbor rules it must meet two requirements:

a. The underlying economic arrangement of the partners must be maintained and accounted for under the detailed capital account maintenance rules contained in the regulations.

b. The tax allocation must be consistent with the underlying economic arrangement of the partners.

The regulations provide three basic economic rules that must be followed under the safe harbor economic effect test, all of which must be provided for in the partnership agreement:

a. Capital accounts must be maintained under the rules provided in the regulations.

b. When a partner's interest in the partnership is liquidated, the partnership must distribute to that partner the actual positive balance, if any, in his capital account.

c. If, after a partner's partnership interest has been completely liquidated, the partner has a deficit capital account, that partner must be obligated to restore the deficit by the later of the end of the tax year or within 90 days after the liquidation of the partner's interest.

The economic effect regulations focus on an analysis of economic or book capital accounts for determining the validity of tax allocations. Surprisingly, very few of these regulations have anything to do with tax allocations; they are concerned with determining book capital accounts, with these capital accounts being the measure of the contribution obligations and liquidating distribution rights of the partners which are economic concepts. Tax items must be allocated consistently with the underlying economic arrangement of the partners as reflected in properly maintained book capital accounts.

However, the economic effect safe harbor regulations, in defining book capital account requirements, go beyond merely setting forth accounting principles to be used to record partnership transactions. The regulations actually mandate how certain transactions are to be recorded in the partners' book capital accounts. For example, the rules may permit only a certain approach or limited approaches to the allocation of economic profits and losses or require a specific treatment of certain contributions and distributions. If capital accounts reflecting these required allocations are then used to measure the actual contribution obligations or liquidating distribution rights of the partners, the capital account rules actually determine the economic relationships of the partners. In other words, these rules dictate to the partners, within certain limits, how they are to share economic profits and losses. Of course, tax regulations cannot actually control the economic relationship of the partners, and that is why the economic effect rules are only safe harbor rules and not mandatory requirements. If the partnership agreement is inconsistent with the economic effect safe harbor rules, the tax allocations may still be valid because they conform to the partners' interests in the partnership.

Under the partners' interests in the partnership rules, there may be many ways to maintain capital accounts that will pass muster under IRC Sec. 704. However, to fall within the safe harbor rules, the capital accounts must be maintained as provided in Reg. 1.704-1(b)(2)(iv).

Economic effect is tested allocation by allocation, and not on an all-or-nothing basis. It is not relevant that, under a particular partnership agreement, a hypothetical allocation would not have economic effect, as long as all of the allocations actually made meet the requirements.

The most common error in applying the substantial economic effect rules is the failure to recognize the distinction between book and tax results. This can result in an attempt to allocate tax items in a manner that is inconsistent with the underlying economic agreement. The problem is often compounded by poorly written partnership agreements that make it difficult to determine the partners' real economic arrangement. Frequently the partners' economic

arrangement cannot be determined by a simple reading of the partnership agreement. For example, different portions of the agreement may conflict (the profit and loss allocation provisions may be different from the contribution provisions, which are different from the distribution provisions), and questions over interpretation arise.

A partnership without a deficit capital account restoration provision in its partnership agreement can still satisfy the economic effect test if it has a qualified income offset.

Allocations provided for in the partnership agreement will be respected if they have substantial economic effect. If the allocations fail to meet these requirements, they will be reallocated according to the partners' interests in the partnership.

Example 2-5: Understanding economic effect—relationship of book and tax allocations.

Larry and Bob each contribute $1,250 cash to a general partnership. The partnership uses $500 in Year One to pay for currently deductible items. There is no other Year One income or loss. The partnership agreement allocates profits and losses 50% to each partner. All allocations are reflected in the partners' book capital accounts, and liquidating distributions are required to be made according to the partners' positive capital account balances. Each partner has a qualifying deficit capital account restoration obligation and the allocations are substantial at the time the partnership agreement is entered into.

In Year One, there is a total book loss of $500 with a corresponding tax loss of $500. Under the economic arrangement, the partners share economic losses 50/50. Thus each partner is allocated $250 of the Year One economic loss. To determine the proper tax allocations, first allocate the book loss among the partners per the terms of the partnership agreement as follows:

	Larry Book	Bob Book	Partnership Book
Contributions	$ 1,250	$ 1,250	$ 2,500
Year One loss	(250)	(250)	(500)
Ending capital	$ 1,000	$ 1,000	$ 2,000

After the economic allocations are made, the tax allocations are made in the manner that is most consistent with the underlying economic allocations. Thus, the economic allocations control the tax allocations. Where the book and tax amounts are the same (as in this case), the proper allocation is obvious (i.e., $250 in tax losses to each partner). Thus, the final book and tax allocations are:

	Larry		Bob		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 1,250	$ 1,250	$ 1,250	$ 1,250	$ 2,500	$ 2,500
Year One loss	(250)	(250)	(250)	(250)	(500)	(500)
Ending capital	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 2,000	$ 2,000

Allocating Cancellation of Debt (COD) Income in a Manner That Has Economic Effect

IRC Sec. 108(a) allows for the exclusion of COD income from gross income under certain conditions. The discharge of a partnership debt is recognized as income and allocated to the partners as a separately stated item. The Section 108 exclusion is applied at the partner level for any COD income. The partners must determine based on their own circumstances if all or part of their distributive share of the COD income can be excluded from their gross income under IRC Sec. 108(a).

If an allocation of a partnership's COD income is made to a partner and it has substantial economic effect, the partner increases his outside basis in his partnership interest. The partner will also receive a capital account increase.

Example 2-6: Allocating cancellation of debt (COD) income.

Fred contributes $10,000 and Ethel contributes $90,000 to form The Mertz Company, a general partnership holding rental property. Fred and Ethel are allocated the partnership's losses 10% and 90% respectively. They share the partnership's income 50% each (income allocations do not first restore previous losses). The partnership maintains capital accounts in accordance with the regulations. Fred and Ethel agree to liquidate according to positive capital account balances. Under state law, Fred and Ethel are jointly and severally liable to creditors for all partnership recourse liabilities. Fred and Ethel do not agree to unconditional deficit restoration obligations; they are obligated to restore deficit capital accounts only to the extent necessary to pay creditors. Fred and Ethel have agreed to a qualified income offset and are treated as having a limited obligation to restore deficit capital accounts by reason of their liability to The Mertz Company's creditors.

The Mertz Company purchased apartment buildings for $1 million from an unrelated seller, paying $100,000 cash and borrowing $900,000 from a bank (that is not the seller of the property). The note is a general obligation of The Mertz Company and neither partner has been relieved from personal liability. The note is payable over six years with interest due semi-annually. Fred and Ethel bear an economic risk of loss equal to $90,000 and $810,000, respectively, for the partnership's $900,000 recourse liability. They increase basis in their partnership interests accordingly. In each of its first five tax years, The Mertz Company had a net loss of $200,000. At the beginning of the sixth year, the FMV of the properties substantially declined. The creditor cancels the debt as part of a workout arrangement. In Year Six, the partners' capital account balances are:

	Fred	Ethel
Initial contribution	$ 10,000	$ 90,000
Loss incurred Years One–Five	(100,000)	(900,000)
Balance at beginning of Year Six	(90,000)	(810,000)
Allocation of Section 108 income according to the partnership agreement	450,000	450,000
Capital balance after COD	$ 360,000	$ (360,000)

The allocation of losses during the first five years meet the economic effect requirements. In Year Six the $900,000 recourse liability is cancelled. The partnership recognizes $900,000 of COD income that must be allocated to Fred and Ethel as a separately stated item.

The partnership agreement provides for income to be allocated equally between Fred and Ethel. However, the allocation of $450,000 of the COD income to each of them does not have substantial economic effect. The cancellation of the debt eliminates both partners' obligation to restore a deficit capital account. Since the deficit restoration obligations were dependent on the cancelled debt, Fred and Ethel are not able to enjoy the economic benefit nor bear the burden of an allocation of COD income exceeding $90,000 or $810,000, respectively.

For the partnership's allocations to have economic effect, the COD income must be allocated $90,000 to Fred and $810,000 to Ethel. This is the same as the decrease in the partners' shares of partnership liability. Fred and Ethel reduce their outside bases (but not below zero) by $90,000 and $810,000, respectively. The regulations treat the deemed distribution as occurring at the end of the partnership's tax year. Thus, Fred and Ethel have basis, and no gain is recognized from the deemed distribution.

Example 2-7: Making allocations using the unconditional deficit restoration obligation.

If Fred and Ethel in Example 2-6 had agreed to unconditional deficit restoration obligations, they would have an obligation to restore deficit capital accounts not only to pay creditors but to satisfy the other partner's positive capital account balance on liquidation. In that case, the allocation of the COD income of $450,000 to Fred and to Ethel would have economic effect and, therefore, would meet the substantial economic effect safe harbor (if substantiality is independently established).

Ethel would be obligated to contribute $360,000 to satisfy Fred's $360,000 positive capital account. She also would recognize a capital gain of $360,000 from the deemed distribution of the $810,000 discharged partnership liability. Fred would have an outside basis of $360,000 and would not recognize any gain.

Understanding the Deficit Capital Account Restoration Requirement

The biggest stumbling block for most partnerships in meeting the economic effect test is the requirement for partners to restore deficit capital accounts. For example, most limited partnerships are formed specifically to limit the liability of investors to make additional capital contributions. To satisfy the restoration requirement, a partner's obligation to restore any negative capital account must be unconditional, and the contribution must be made by the later of the end of the tax year of the liquidation or within 90 days after the date of liquidation. The negative capital account restoration requirement may be found in the written or oral partnership agreement among the partners, or may be a function of state or local law. Practitioners should be careful in relying on local law, as it may not clearly meet the end-of-year or 90-day time period requirement (although, irrespective of meeting either requirement, any local law assigning liability would probably meet the partners' interests in the partnership test). If any partner is not required to restore his negative capital account, the partnership does not fall within the safe harbor rules unless it complies with the alternative qualified income offset rules.

In addition to contributing cash or assuming partnership obligations, a partner can meet the deficit capital account restoration requirement by giving the partnership a personal promissory note upon liquidation. The note itself is treated as satisfying the contribution obligation (in lieu of a current cash contribution or debt assumption) provided that:

a. the note is contributed within the time required (i.e., the later of year-end or 90 days after liquidation),

b. the note is negotiable, and

c. the partner contributes to the partnership, within the required period, the excess of the principal balance of the note over its FMV at the time of liquidation. (The principal of the note is deemed to equal the note's FMV, provided the interest rate on the note is not less than the applicable federal rate at the time of valuation.)

The deficit capital account restoration requirements are designed to be somewhat flexible. To prevent abuse, a partner is not treated as having an obligation to restore a deficit capital account if the obligation is not legally enforceable or if the facts and circumstances indicate a plan to avoid or circumvent the obligation.

The capital accounts that must be restored under the economic effect rules are the economic capital accounts (sometimes called the book capital accounts)—these capital accounts may have nothing to do with tax-basis capital accounts. In some cases, the amount and treatment of items in the book and tax capital accounts of a partnership are identical, but this is often not the case. Once economic results have been allocated, the allocation of tax items follows in conformity with the economic allocations. (In the remainder of this course and in the examples that follow, the terms *economic* and *book* are used interchangeably.)

Any payment made to restore a negative capital account must either be distributed to the other partners according to their positive capital accounts (no later than at the time of the liquidation of their partnership interests) or paid to partnership creditors. This requirement to pay creditors is not a creditor relief provision, and restoration of a capital account by payment to creditors can be accomplished if the partner assumes the partnership's debt owed to the creditor.

If a partner does not have a deficit restoration obligation or if he has only a partial deficit restoration obligation (i.e., limited to a fixed dollar amount), allocations of economic loss that create a negative capital account in excess of what the partner is obligated to restore (if anything) do not pass the economic effect test. (See Example 2-8.) The losses are required to be reallocated among the partners who actually bear the economic risk relating to the losses.

Rev. Rul. 97-38 addresses a partner's limited deficit restoration obligation under Reg. 1.704-1(b)(2)(ii)(c) when the partner is liable to the partnership's creditors. When the partner's liability to the partnership's creditors causes him to have a limited deficit restoration obligation, the partner's limited deficit reduction allocation equals the money the

partner would have to contribute to satisfy partnership liabilities if all partnership property were sold for the partnership's book basis. Computing the partner's deficit restoration obligation may require application of the Section 704(b) valuation regulations if a partner's obligation is dependent on the value of the partnership's assets.

Example 2-8: Planning for negative capital accounts with a deficit restoration requirement.

Phil and Charlie form a general partnership with each partner contributing $1,000 cash. The partnership purchases depreciable property for $5,000 using the $2,000 cash and borrowing $3,000 on a recourse loan for which both partners are liable. The property is depreciated using the straight-line method over five years for both tax and economic (book) purposes.

Phil needs tax losses. Therefore, the partners specify in the partnership agreement that all losses will be allocated 100% to Phil, and all profits will be allocated first to chargeback for the specially allocated losses. Thereafter, profits are split equally. The agreement also adopts the safe harbor capital account provisions [book capital accounts will be maintained under Reg. 1.704-1(b)(2)(iv); all allocations will be reflected in the partners' book capital accounts; the partnership will be liquidated by book capital accounts; and partners with negative book capital accounts on liquidation will restore the deficit within the required time period]. The partnership leases the property to a third party. During Year One, the partnership has a net loss of $1,000 arising from depreciation that was allocated entirely to Phil.

In Year Two, the partnership's rental income continues to equal its operating expenses, resulting in a $1,000 net loss arising from the depreciation deduction. According to the partnership agreement, this loss is allocated 100% to Phil.

Since the partnership agreement provides for the restoration of negative book capital accounts on liquidation, the loss allocation to Phil is allowed, even though his capital account becomes negative while Charlie's remains positive. If the partnership were liquidated and the asset sold for book value (a mandatory assumption for testing an allocation under the economic effect rules), Phil would be required to restore his negative book capital account and would, therefore, bear the burden of the special loss allocation. Phil's contribution would result in the partnership having sufficient funds to pay Charlie his positive book capital account balance. Therefore, the book and corresponding tax allocations for Year Two are as follows:

Phil's deficit book capital account restoration obligation means that he bears the economic burden of the book losses allocated 100% to him. Accordingly, allocating 100% of the tax losses to Phil in Year Two is allowed under the safe harbor rules.

	Phil		Charlie		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ —	$ —	$ 1,000	$ 1,000	$ 1,000	$ 1,000
Year Two loss	(1,000)	(1,000)	—	—	(1,000)	(1,000)
Ending capital	$ (1,000)	$ (1,000)[a]	$ 1,000	$ 1,000	$ -0-	$ -0-

Note:

[a] Phil's tax basis is increased by his share of partnership liabilities. Therefore, he has sufficient tax basis to allow the flow-through of the loss. The economic and tax allocation would be valid even if Phil did not have enough tax basis in his partnership interest to take the tax deduction. However, under the Section 704(d) rules, Phil could not deduct the losses in Year Two because he has no remaining tax basis. Phil would have to carry the disallowed losses forward to a future year when he has sufficient tax basis to deduct them.

Phil's deficit book capital account restoration obligation means that he bears the economic burden of the book losses allocated 100% to him. Accordingly, allocating 100% of the tax losses to Phil in Year Two is allowed under the safe harbor rules.

Now assume the partnership agreement in Example 2-8 did not require Phil to restore his deficit book capital account. However, the partnership agreement does contain a qualified income offset provision. To be within the safe harbor allocation rules, a partner must be required to restore his deficit book capital account or there must be a qualified income offset provision.

The existence of a qualified income offset provision, however, does not automatically mean that allocations of losses to a partner are allowed. The agreement must also provide that no book losses will be allocated to the partner to the extent that the losses would cause the partner's book capital account to become negative, or more negative, in excess of the partner's deficit capital account restoration obligation. The allocation of losses to Phil in Year Two causes his book capital account to go to $(1,000). Thus, the loss allocation for Year Two is not allowed because Phil is not required to restore his negative capital account.

Although the failure of the intended allocation for Year Two in the preceding example is fairly obvious, will the potentially disallowable deduction in Year Two affect the allocation in Year One, or does each year stand on its own? The Year One allocation is not affected. A basic tenet of our tax system is that accounting is done on a year-by-year basis, and the regulations adopt that position for testing allocations. Thus, it is not necessary that an agreement meet the capital account analysis test (either under the safe harbor rules or the partners' interests in the partnership rules) in all eventualities, but only that the particular allocation for a given year is valid. In this analysis, however, subsequent events may impact current allocations. For example, if a partner were allocated losses causing his capital account to become negative based on a current deficit capital account restoration obligation, but the agreement provides that the obligation is terminated at some specified future time, the current loss allocation may not be allowable. If an allocation is partially allowable and partially in violation of the rules, the allowable portion is permitted. The test is not an all-or-nothing test.

Relying on Qualified Income Offset as an Alternative to the Deficit Restoration Requirement

The basic safe harbor economic effect rules require that at all times during a partnership's life all partners be obligated to make contributions to restore their negative capital accounts, if any, upon liquidation of the partnership. However, many partnerships, including virtually all limited partnerships, LLCs, and LLPs provide that some of the partners have limited liability for partnership losses. As previously discussed, many limited partnerships have no requirement for limited partners to make contributions beyond their initial contributions. Even though such partnerships do not comply with the deficit capital account restoration provisions, they may still fall within the substantial economic effect safe harbor by using the qualified income offset rules. The qualified income offset provides an alternative to the often unacceptable requirement that all partners be obligated to restore their negative book capital accounts.

While a partner who is not required to restore a negative book capital account cannot be allocated economic losses that would cause his book capital account to become negative, a partner's capital account can nevertheless become negative because of items other than economic loss allocations. For example, the partnership can make a distribution of cash that causes a partner's capital account to become negative. The qualified income offset provision is intended to correct for such items that cause a negative book capital account. (Note that a qualified income offset provision does not enable a partnership to allocate losses to a partner if the allocation would create a negative book capital account. The qualified income offset rules only allow the partnership to qualify under the substantial economic effect safe harbor without including a deficit restoration obligation in the partnership agreement.)

Under the qualified income offset rules, a loss allocation to a partner without an unlimited deficit capital account restoration obligation can still qualify under the substantial economic effect safe harbor if the partnership agreement meets three requirements:

a. The partnership agreement must meet the first and second elements of the economic effect test. That is, it must (1) maintain book capital accounts under the economic effect safe harbor capital account rules, and (2) liquidate according to positive book capital accounts.

b. The partnership must, before allocating losses, make certain *special adjustments* to the partner's book capital account.

c. The partnership agreement must have a qualified income offset provision.

The *special adjustments* requirement provides that the partner's book capital account must be reduced in advance—and before any allocation of current year economic losses—for the following items, to the extent that they are reasonably expected to occur (including in future tax years):

a. Certain oil and gas percentage depletion allowances.

b. Certain allocations of tax loss and deductions under the family partnership rules.

c. Allocations of tax loss and deductions under IRC Sec. 706(d) (allocations of cash-basis items when partner's interest changes).

d. Allocations of tax loss recognized by the partnership on a distribution of Section 751 unrealized receivables or inventory.

e. Distributions to the partner in excess of increases in the partner's book capital account during (or prior to) the year of distribution.

If, after reduction for the preceding items, the partner's book capital account is negative (by an amount in excess of the partner's obligation to restore a deficit), no further allocations of economic loss can be made to the partner.

The requirement for advance reductions in a partner's book capital account for the preceding items deals with expected results. The purpose of a qualified income offset provision is to deal with unexpected reductions in the partners' capital accounts for the above items. A qualified income offset provision provides that a partner who unexpectedly receives any of the adjustments, allocations, or distributions described above that result in a deficit (or increased deficit) book capital account must be allocated items of gross income and gain in an amount and manner sufficient to eliminate the deficit as quickly as possible. In effect, the qualified income offset provision forces the partner to recognize economic income in order to restore excess economic losses or distributions that caused a negative book capital account. An allocation of economic income as a result of the qualified income offset rules results in a corresponding allocation of taxable income.

While the regulations do not define the term *unexpected*, it is certain that the term does not mean that the applicable distribution or allocation is completely unforeseen. The determination of whether an item is expected is a question of fact and depends on specific circumstances. For example, if a partnership plans at some time in the indefinite future to refinance its (hopefully) appreciated property and distribute the proceeds, it is unlikely that the distribution is expected until, at the minimum, the property has appreciated and the partnership has developed a specific refinancing plan. Perhaps the distribution is not expected until the loan application has been made and the property appraised. The following are examples of situations in which the distributions would likely be treated as *expected*:

a. The promoters of a limited partnership guarantee that minimum distributions, or a minimum return, will be received by investor partners.

b. The partnership holds funds in the partnership account pending distribution.

c. Partners make contributions to a partnership for the purpose of increasing their capital accounts so that a loss can be allocated to them, with the understanding that after the loss allocation the contributions will be returned to the partners.

The potential abuse that the rule concerning unexpected allocations and distributions is designed to prevent is easy to understand. For example, assume that a partner has a $100 book capital account and is not obligated to restore any negative capital account, that the partnership has appreciated property of which the partner's share is $100, and that the partnership intends to allocate a $100 recourse loss to the partner for Year One. If the partnership refinances the property and distributes the cash before year-end, the partner's capital account is reduced to zero, and he cannot be allocated the economic loss because it would result in his capital account becoming negative. If, however, the refinancing and distribution did not take place until Year Two (and was not treated as expected during Year One), the loss allocation in Year One would be allowed. The subsequent distribution to the partner, resulting

in a negative capital account, has no effect on the validity of the prior year loss allocation. Because of these different results, the partnership might be tempted to hold the distribution of cash until Year Two. In that way the partner's capital account would not be zero when the loss allocation from Year One is made. However, since the distribution in Year Two would clearly be expected, under the qualified income offset rules it is deemed to have occurred in Year One, reducing the partner's capital account to zero for testing the Year One loss allocation. Therefore, the partner cannot receive any loss allocation in Year One.

The most common situation triggering the operation of a qualified income offset provision is the refinancing of appreciated property. If the partnership distributes the excess cash from refinancing, the book capital accounts of some or all partners may become negative. A qualified income offset provision restores as soon as possible (by an allocation of gross income, if necessary) the negative capital accounts of the affected partners rather than allowing the partnership to wait until the ultimate sale of the refinanced property at a gain to restore negative capital accounts.

A qualified income offset requires the partnership to allocate items of gross income and gain to the partner who has an unexpected deficit capital account but no obligation to restore it. Correspondingly, the other partners are allocated gross deductions and losses of an equal amount. At some point in the future, the partnership is required to make a curative allocation (when the opportunity arises) to restore the balance between the partners' capital accounts. Otherwise, the economic arrangement among the partners will likely be distorted by the qualified income offset allocation.

The safe harbor rules provide that if a partner is not required to restore his negative capital account, and the partnership agreement complies with all of the requirements under the qualified income offset regulations, certain special adjustments are required for the capital account of the partners with no deficit capital account restoration requirement. One of the required adjustments is to treat all *reasonably expected* cash distributions as currently reducing the partners' capital accounts even though the distributions have not in fact occurred.

ALLOCATIONS THAT HAVE A SUBSTANTIAL EFFECT

Understanding When an Allocation Is Substantial

In addition to having economic effect, an allocation must also be substantial to be recognized under the substantial economic effect safe harbor test. An allocation is substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts to be received by the partners, independent of tax considerations.

An allocation is not substantial if, at the time the allocation becomes part of the partnership agreement (a) the after-tax economic consequences of at least one partner, in present value terms, may be enhanced compared to the partner's after-tax consequences if the allocation were not contained in the partnership agreement, and (b) there is a strong likelihood that no partner's after-tax economic consequences will, in present value terms, be substantially diminished compared to that partner's consequences if the allocation were not contained in the partnership agreement. In other words, an allocation will not be substantial if, on an after-tax, present-value basis, the allocation benefits at least one partner without any substantial cost to the other partners.

The substantiality test is independent of the economic effect test, and the fact that an allocation has economic effect has no bearing on the issue of substantiality. Consequently, an allocation can meet all of the requirements of the economic effect capital account maintenance rules and still fail because it is determined to be insubstantial.

In Rev. Rul. 99-43, the IRS ruled that partnership special allocations lacked substantiality under Reg. 1.704-1(b)(2)(iii) when the partnership agreement was amended to specially allocate items after the events creating them had occurred, and the overall economic effect of the allocations on the partners' capital accounts did not differ substantially from the economic effect of the original allocations in the agreement.

Unlike the economic effect test, which is primarily an economic analysis, the substantial effect test is a mixture of economic and tax analysis. In determining the after-tax economic benefit or detriment, nonpartnership tax consequences must be considered. It is impossible to tell, simply by looking at a specific allocation, whether or not it is substantial without knowledge of the individual partners' tax situations and the circumstances under which the allocation agreement was originally made.

Regulations on Tiered Ownership

Regulations issued in May 2008 address how the substantial effect rules apply to tiered ownership structures, including pass-through entities. The regulations are effective for partnership tax years beginning on or after May 19, 2008. Under the regulations, when testing the substantiality of partnership allocations to a partner that is a pass-through entity, the tax attributes of owners (whether directly or indirectly) of the pass-through entity must be taken into account. For this purpose, a pass-through entity includes partnerships, LLCs classified as partnerships, S corporations, trusts and estates, certain controlled foreign corporations, and disregarded entities.

Indirect ownership is determined in accordance with the principles of IRC Sec. 318, substituting "10%" for "50%" each time it appears.

For purposes of applying this provision, the tax attributes of *de minimis* partners need not be taken into account. A *de minimis* partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10% of the capital and profits of a partnership, and who is allocated less than 10% of each partnership item of income, gain, loss, deduction, and credit.

The regulations also clarify that when applying the substantial effect tests, the after-tax economic consequences of a partner resulting from an allocation or allocations must be compared to the after-tax economic consequences to that partner if the allocation or allocations were made in accordance with partner's interest in the partnership (PIP).

Example 2-9: Applying the regulations to allocations involving pass-through entities.

Olympia Providers Partnership has three equal partners, Adam Urkel, Eden Corp. (an S corporation wholly owned by Carl Tacoma), and Cable Partners (a general partnership owned equally by Eve Moses and Jack Everett). When applying the rules for determining if Olympia's tax allocations have substantial effect, the allocation of items to Carl, Eve, and Jack must be considered, as well as the allocations to Olympia's direct partners.

These regulations make the practitioner's job even more difficult, since he or she must now obtain information concerning the tax situation of the owners of any pass-through entity partners. Practitioners should include a statement in the transmittal letter for an affected return that describes the information or assumptions the practitioner used to determine if the partnership's allocations have substantial effect.

Recognizing When a Shifting Allocation Occurs

A shifting tax consequence occurs when both of the following exist:

a. The net increases and decreases in the partners' book capital accounts for the tax year are substantially what they would have been if the allocations were not made.

b. The total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account each partner's tax attributes).

If a shifting allocation occurs, there is a presumption that the allocation is insubstantial. The presumption may be overcome by a showing of facts and circumstances that prove otherwise.

Example 2-10: Determining if an allocation is insubstantial under the shifting allocation rule.

Ann and Bob are equal partners in AB Partnership. AB has $100 of capital gain and $100 of ordinary income. Bob has a $100 capital loss carryforward outside the partnership that he is otherwise unable to use. Therefore, the partners agree that Bob will be allocated $99 of the partnership capital gain, and Ann will be allocated $1 of the capital gain and all $100 of the ordinary income.

The allocation will likely be treated as insubstantial under the shifting allocation rule. Ann's and Bob's capital accounts have been credited for approximately the same dollar amount as if the special allocation had not been made, yet Bob's tax liability has been substantially reduced because of his ability to offset the capital gain with his otherwise unusable capital loss carryforward.

The allocation would be substantial, however, if Ann and Bob had simply agreed that Bob would be allocated all capital gains from the partnership and Ann all other income and, at the time the allocation was agreed to the partners, neither knew what the relative capital gains and ordinary income of the partnership would be, nor that Bob would have a special tax need for capital gains versus ordinary income. (See Example 2-11.)

Examples of special allocations that frequently indicate the presence of shifting allocations are special allocations of tax-exempt income, Section 1231 gains, capital gains, or foreign source income.

Example 2-11: Recognizing situations that may result in a shifting allocation.

Carl and Richard have been equal partners for many years in a calendar-year general partnership. In the current tax year, the partnership earned $50,000 of ordinary income (passive nonportfolio income from rental property) and $46,000 of tax-exempt income. Richard has substantial passive losses that he is otherwise unable to currently use. They decide to allocate all of the ordinary income to Richard and all of the tax-exempt income to Carl. They make this agreement prior to the due date of the tax return, under IRC Sec. 761(c). The partnership agreement provides for proper adjustments of book capital accounts and liquidation based on capital account balances (i.e., the allocations have economic effect). As a result of the current year income allocation, Richard will receive $4,000 more than Carl when the partnership is liquidated.

Both partners receive an after-tax benefit from the allocation because of their tax circumstances. The after-tax economic results to the partners without the special allocation would be as follows:

	Carl	Richard	Total
Partnership share			
Tax-exempt income	$ 23,000	$ 23,000	$ 46,000
Rental income	25,000	25,000	50,000
Subtotal	48,000	48,000	96,000
Less taxes on			
Tax-exempt income	—	—	—
Rental income	(9,000)	—	(9,000)
Net cash after taxes	$ 39,000	$ 48,000	$ 87,000

The after-tax economic results to the partners with the desired allocation would be as follows:

	Carl	Richard	Total
Partnership share			
Tax-exempt income	$ 46,000	$ —	$ 46,000
Rental income	—	50,000	50,000
Subtotal	46,000	50,000	96,000
Less taxes on			
Tax-exempt income	—	—	—
Rental income	—	—	—
Net cash after taxes	$ 46,000	$ 50,000	$ 96,000

The special allocations to Carl and Richard are not substantial since, as a result of the special allocations, both partners are better off after taxes. This is an example of a shifting allocation, as the impact of the allocation affects only a single year. (See Example 2-14 for a discussion of transitory allocations.)

If the partners in the preceding example had entered into the same special allocation agreement at the beginning of the year, and at the time of the allocation agreement the partners had no expectation of deriving individual tax benefits from the special allocation, then perhaps there would not have been the requisite strong likelihood at the time of the allocation agreement, and the allocation would stand up even though the ultimate tax benefits were exactly as above.

Allocations of cancellation of debt (COD) income are considered *shifting allocations* when the partners amend the partnership agreement to specially allocate COD income that arises from a related valuation after the event that

created the COD income has occurred, and the overall economic effect of the special allocations on the partners' capital accounts does not differ substantially from the economic effect of the original allocations in the partnership agreement.

Identifying Transitory Allocations

A transitory tax allocation occurs if one or more allocations will be largely offset by one or more other allocations in future years, and there is a strong likelihood that:

a. the net increases and decreases in the partners' book capital accounts would have been substantially the same as if the offsetting allocations had not been made, and

b. the total tax liability of the partners will be less than if the allocations had not been made.

If these two circumstances occur (i.e., offsetting allocations plus total tax savings), it is presumed that there is the requisite *strong likelihood* at the time of the allocation agreement. This presumption can be overcome by a showing of facts and circumstances that prove otherwise.

Example 2-12: Determining if a transitory allocation is substantial.

Ann and Bob are equal partners in AB Partnership. AB has $100 of gross income and $100 of deductions in its current tax year, and the partnership has high expectations of the same results in the following year. Individually, Ann has taxable income and Bob has unused tax losses. Consequently, the partners agree to allocate the gross income to Bob and the deductions to Ann in the first year and matching deductions to Bob and gross income to Ann in the second year. Additionally, the partners agree that the partnership cannot be liquidated until after the second year, thus ensuring that the offsetting allocations will occur.

The allocations will likely be treated as insubstantial transitory allocations because, over the two-year period, the effect on the partner's capital accounts is essentially the same as if no special allocations were made. The only real impact of the allocation is the tax benefits gained by the partners.

Example 2-13: Including a chargeback provision in the partnership allocation.

Ann and Bob agree to form a partnership where Ann, an inventor, will develop a product and Bob will finance it. All losses will be allocated to Bob, and thereafter all profits will be allocated to Bob until he has recovered his losses (a chargeback provision). After Bob's losses are recovered, profits will be shared equally. As the success of the venture cannot be assured, the loss allocations to Bob and the subsequent chargeback allocations to recover those losses are considered substantial allocations irrespective of the time period of recovery or the expectations of the partners for rapid success.

Even though a transitory allocation would otherwise be treated as insubstantial, if there is a strong likelihood at the time the allocation becomes part of the agreement that the offsetting allocations will not, in large part, be made within five years of the original allocations (on a first-in, first-out basis), then the allocations are considered substantial. This is a safe harbor for chargebacks from sources other than sales of property.

Example 2-14: Using income chargebacks (transitory allocations).

Carol and Donna form a general partnership to acquire and lease machinery. Each contributes $50,000, which they use to buy equipment for $100,000. They lease the equipment to a financially secure corporation on a 13-year triple net lease. The partnership incurs no operating expenses in connection with the equipment as these expenses are paid by the lessee. Given the financial stability of the lessee, there is a strong likelihood that the partnership will have highly predictable losses in the first six years of ($10,000), ($9,000), ($8,000), ($7,000), ($6,000), and ($5,000), respectively (resulting from cost recovery deductions), and highly predictable income of $4,000, $5,000, $6,000, $7,000, $8,000, $9,000, and $10,000 in years 7–13, respectively.

The partnership agreement complies with all of the safe harbor requirements for maintaining book capital accounts and liquidating according to book capital accounts. Each partner is obligated to contribute to

restore negative capital accounts. Carol has a need for tax deductions, and Donna does not. Therefore, they agree that during the first five years Carol will be allocated 90% of all losses and Donna 10% of such losses. Thereafter, profits will be allocated 90% to Carol and 10% to Donna until each has been allocated an amount of profits equal to the losses previously allocated (a loss chargeback arrangement). After that, profits and losses will be allocated 50/50. The partners further agree that all cash flow will be divided equally.

Assume that after considering the individual tax situations of Carol and Donna, the allocations result in a total tax savings to the partners, and each partner's capital account ends up being substantially the same as if no special allocation had been made. Is the special allocation of losses to Donna offset by the subsequent chargeback allocation of expected profits substantial?

Carol and Donna's desired allocation scheme clearly fails the two-part general test—the allocations would be insubstantial under the general rule. The lease is to a financially secure corporation, and the income stream is, therefore, assured and predictable. The losses are solely a function of the cost recovery deductions that are predictable, and the allocation of the losses between the partners creates a net tax savings at no cost to any of the partners.

However, the regulations provide a special safe harbor for otherwise transitory allocations that take an extended period to turn around. If the original and offsetting allocations (on a first-in, first-out basis) do not largely occur within five years of each other, the transitory allocations are considered to be substantial. (See Example 2-15 for an example of a chargeback based on gain allocations.) Because the early year special allocations of losses to Carol will not turn around within five years, the allocation scheme is considered substantial under the safe harbor exception to the general transitory allocation rule. The five-year rule is only a safe harbor. An income chargeback that occurs in less than five years does not cause a substantiality problem if, at the time of the earlier loss allocation, there was significant doubt that the offsetting income would be earned.

Chargebacks Involving Gain or Loss from the Sale of Property

In general, special allocations of depreciation and corresponding chargeback allocations of the gain recognized on disposition of the property qualify as substantial since the gain is treated as being unexpected. This is the result of a rule providing that, for determining if an allocation is substantial, the property's adjusted tax basis (or the book capital account value of the property, if property is properly reflected on the partnership books at a book value different from the property's tax basis) is deemed to be its FMV. Adjustments to basis (or book value), for example, due to depreciation based on tax accounting rules, are presumed to be matched by a corresponding decrease in the property's FMV. Since the decrease is deemed to be a real economic loss, there cannot be a strong likelihood that the economic effect of an allocation will be largely offset by an expected allocation of gain from the disposition of the property.

Example 2-15: Using gain chargebacks (transitory allocations).

Assume the same facts as in Example 2-14, except at the beginning of year seven when the tax and book basis of the equipment is zero, the partnership sells the equipment (subject to the lease) for $120,000. The partnership agreement provides that partnership income (including gains on the sale of assets) will be allocated 90% to Carol until she has been charged back for the losses that were allocated 90% to her. Is the special allocation of the losses followed by an offsetting gain chargeback allocation substantial?

The regulations assume the FMV of partnership property is its book value adjusted for book depreciation, depletion, and amortization. Accordingly, gain chargeback allocations are not deemed to be transitory since there is assumed to be no strong likelihood that the gains will actually be realized. This assumption that FMV equals book value holds true even though the partnership property may actually be appreciating rather than depreciating. Therefore, the gain chargeback allocation is not treated as an insubstantial transitory allocation even though the loss allocations may be fully charged back in less than five years.

In summary, chargeback allocations—allocations of loss or income matched by an offsetting allocation in a later year—are not automatically insubstantial. If the offsetting allocation from operations is not expected to occur within

five years, or if the offsetting allocation is dependent on gain or loss from the sale of partnership property, the chargeback is within the substantiality safe harbor.

Right of a Partner to Reject a Special Allocation

There is nothing to prevent a partner from challenging the income tax effect of a special allocation of partnership items. For example, a partner pressured into an agreement that results in tax benefits being allocated to the other partners may become dissatisfied, or the partnership tax return may have been filed in a manner contrary to the agreement of the partners.

The best manner to ensure that the tax benefits of special allocations are carried out is to specifically detail the allocation in the partnership agreement and also to spell out in detail the tax consequences of the allocation. The provision should specify that the partners understand the income tax implications and agree not to take a position for tax purposes inconsistent with the provision. An opposing partner can still cause problems, but at least there will be written documentation stating the tax implications of the allocation. This should serve as a deterrent to any partner taking an inconsistent income tax position at a later date.

If a partner rejects a special allocation, the partner should file his or her individual tax return in the manner consistent with the partner's interpretation of the allocation, even though this reporting is inconsistent with the partnership return and the Schedule K-1 furnished to that partner. A partner who does file inconsistently should notify the Service of the inconsistency as required by IRC Sec. 6222(b).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. The Mac-2 Partnership plans to rely on the substantial economic effect safe harbor rules. Which of the following is an economic rule that the partnership must provide for in its partnership agreement?

    a. The partnership's capital accounts must be maintained under generally accepted accounting principles (GAAP).

    b. Once a partner's interest is liquidated, he or she is no longer obligated to restore any deficits in his or her capital account.

    c. A partner cannot receive tax allocations that exceed the amount of book income allocations made to that partner in a tax year.

    d. If one of the partners liquidates his or her partnership interest, Mac-2 must distribute any actual positive balance of the partner's capital account to the partner.

11. The Brinkman-Alston Partnership plans to rely on the safe harbor rules. What is the most common error that partnerships make when applying these rules (an error that the Brinkman-Alston Partnership should strive to avoid)?

    a. Testing economic effect on an all-or-nothing basis.

    b. Maintaining capital accounts based on the partners' interests in the partnership.

    c. Not recognizing the distinction between tax and book results.

12. A creditor of the SAHM Partnership, discharges a partnership debt. This amount is recognized as income and is allocated to the partners of the SAHM Partnership as a separately stated item. Which of the following would happen next under these circumstances?

    a. A qualified income offset is added to the partnership agreement.

    b. The partners determine if their share of the income can be excluded from gross income.

    c. The allocations will be reallocated according to the partners' interests in the partnership.

    d. The partners' outside basis in the partnership interest will increase.

13. Upon liquidation, Edmund plans to meet his partnership's deficit capital account restoration requirement by giving the partnership a personal promissory note. Which of the following is one qualification that Edmund's promissory note must meet?

    a. His note must be negotiable.

    b. The note must pledge to restore both his economic and tax-basis capital account.

    c. He must contribute the FMV of the note to the partnership within the required period.

    d. He must contribute the note by 90 days after liquidation.

14. Assume all of the following individuals are partners in partnerships relying on the safe harbor rules. Each of these partners has a deficit capital account upon liquidation. Which of these partners would cause the partnership to fail the economic effect test?

    a. Under the partnership agreement, Emily's deficit restoration is limited to a fixed dollar amount that is less than the deficit in her account.

    b. The payment Fred makes to restore his capital account is distributed to the other partners in his partnership.

    c. George assumes partnership debt in the amount of his deficit account and pays the amount to the creditor.

    d. Hannah is a limited partner not required to restore her deficit capital account, but her partnership agreement includes a qualified income offset provision.

15. The Lincoln Partnership has a limited partner who is not required to restore a negative capital account. The partnership agreement includes a qualified income offset provision. Which of the following is a special adjustment that the partnership must make to the limited partner's account so the partnership allocations will still qualify under the substantial economic effect safe harbor?

    a. The account must be credited in advance for allocations of cash-basis items.

    b. The account must be reduced in advance for all oil and gas profits.

    c. The account must be reduced in advance for tax loss allocations on Section 751 inventory distributions.

    d. No allocations of economic loss can be made to a limited partner.

16. When would a partnership allocation be deemed *insubstantial*?

    a. If, after taxes and on a present-value basis, the allocation benefits at least one partner, but there is no substantial cost to the other partners.

    b. If it is inconsistent with the underlying economic arrangement of the partners.

    c. If it exceeds 100% of the amount of income, gain, loss, and deduction allocated to a partner for tax purposes.

    d. If the partnership agreement is not specially amended for the allocations after the events creating them occurred.

17. The Rosewater Partnership makes an allocation. Upon closer examination, the net increases and decreases in the book capital accounts of the partners are substantially what they would have been if this allocation had not been made. After the allocation, the partners' total tax liability is less than if the allocation was not contained in the partnership agreement. What is this an example of?

    a. An insubstantial allocation.

    b. A shifting allocation.

    c. A transitory allocation.

    d. A tiered ownership structure.

18. The Jefferys-Mathews Partnership has a transitory allocation; however, at the time the allocation became part of the partnership agreement, there was a strong likelihood any offsetting allocations would not be made within five years of the original allocation. How would this allocation be classified?

    a. Substantial.

    b. Insubstantial.

19. Zach is a member of the Cousin Partnership. The partnership agreement is amended to include a special allocation; however, Zach disagrees with this allocation. What action can Zach take in this situation?

    a. Because the allocation is added to the partnership agreement, Zach has no choice but to file his tax return the same way as the other partners in the Cousin Partnership.

    b. Zach can file his tax return consistent with his interpretation of the allocation, even if that differs from the partnership return and his Schedule K-1.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

10. The Mac-2 Partnership plans to rely on the substantial economic effect safe harbor rules. Which of the following is an economic rule that the partnership must provide for in its partnership agreement? **(Page 112)**

    a. The partnership's capital accounts must be maintained under generally accepted accounting principles (GAAP). [This answer is incorrect. Under the IRS regulations for the safe harbor economic effect test, Mac-2's partnership agreement must specify that the capital accounts will be maintained under the rules provided in the regulations, not GAAP.]

    b. Once a partner's interest is liquidated, he or she is no longer obligated to restore any deficits in his or her capital account. [This answer is incorrect. According to the economic effect regulations, Mac-2's partnership agreement must specify that if, after a partner's partnership interest has been completely liquidated, the partner has a deficit capital account, that partner is obligated to restore the deficit by the later of the end of the tax year or within 90 days after the liquidation of the partner's interest.]

    c. A partner cannot receive tax allocations that exceed the amount of book income allocations made to that partner in a tax year. [This answer is incorrect. This is not one of the economic rules that the regulations require partnerships to include in their partnership agreement. The economic effect regulations focus on an analysis of economic or book capital accounts for determining the validity of tax allocations. Surprisingly, very few of these regulations have anything to do with tax allocations; they are concerned with determining book capital accounts, with these capital accounts being the measure of the contribution obligations and liquidating distribution rights of the partners which are economic concepts.]

    d. If one of the partners liquidates his or her partnership interest, Mac-2 must distribute any actual positive balance of the partner's capital account to the partner. [This answer is correct. The regulations provide three basic economic rules that must be followed under the safe harbor economic effect test, all of which must be provided for in the partnership agreement. One of these three rules is that when a partner's interest in the partnership is liquidated, the partnership must distribute to that partner the actual positive balance, if any, in his capital account. Therefore, Mac-2 should make this rule part of its partnership agreement.]

11. The Brinkman-Alston Partnership plans to rely on the safe harbor rules. What is the most common error that partnerships make when applying these rules (an error that the Brinkman-Alston Partnership should strive to avoid)? **(Page 112)**

    a. Testing economic effect on an all-or-nothing basis. [This answer is incorrect. Under the IRS regulations, economic effect is tested allocation by allocation, and not on an all-or-nothing basis. It is not relevant that, under a particular partnership agreement, a hypothetical allocation would not have economic effect, as long as all of the allocations actually meet the requirements. However, this is not the most common error.]

    b. Maintaining capital accounts based on the partners' interests in the partnership. [This answer is incorrect. This is not an error. Partnerships can choose whether to use the safe harbor rules or to use the partners' interests in the partnership rules. Under the partners' interests in the partnership rules, there may be many ways to maintain capital accounts that will pass muster under IRC Sec. 704. However, to fall within the safe harbor rules, the capital accounts must be maintained as provided in Reg. 1.704-1(b)(2)(iv).]

    c. Not recognizing the distinction between tax and book results. [This answer is correct. The most common error in applying the substantial economic effect rules (as they are described in the IRS regulations) is the failure to recognize the distinction between book and tax results. This can result in an attempt to allocate tax items in a manner that is inconsistent with the underlying economic agreement. This problem is often compounded by poorly written partnership agreements that make it difficult to determine the partners' real economic arrangement.]

12. A creditor of the SAHM Partnership, discharges a partnership debt. This amount is recognized as income and is allocated to the partners of the SAHM Partnership as a separately stated item. Which of the following would happen next under these circumstances? **(Page 113)**

    a. A qualified income offset is added to the partnership agreement. [This answer is incorrect. A partnership without a deficit capital account restoration provision in its partnership agreement can still satisfy the economic effect test if it has a qualified income offset. However, that does not affect the issue described in this scenario.]

    b. The partners determine if their share of the income can be excluded from gross income. [This answer is correct. IRC Sec. 108(a) allows for the exclusion of cancellation of debt (COD) income from gross income under certain conditions. The discharge of a partnership debt is recognized as income and allocated to the partners as a separately stated item. The Section 108 exclusion is applied at the partner level for any COD income. The partners must determine based on their own circumstances if all or part of their distributive share of the COD income can be excluded from their gross income under IRC Sec. 108.]

    c. The allocations will be reallocated according to the partners' interests in the partnership. [This answer is incorrect. According to the IRS regulations, allocations provided for in the partnership agreement will be respected if they have substantial economic effect. If the allocations fail to meet these requirements, they will be reallocated according to the partners' interests in the partnership. However, the validity of the allocation is not the issue in this scenario.]

    d. The partners' outside basis in the partnership interest will increase. [This answer is incorrect. According to the Internal Revenue Code, if an allocation of a partnership's COD income is made to a partner and it has substantial economic effect, the partner increases his outside basis in his partnership interest. While this is a possibility for the partners in the SAHM Partnership, there is another step that must happen between the events in the scenario and an increase in outside basis.]

13. Upon liquidation, Edmund plans to meet his partnership's deficit capital account restoration requirement by giving the partnership a personal promissory note. Which of the following is one qualification that Edmund's promissory note must meet? **(Page 115)**

    a. His note must be negotiable. [This answer is correct. According to the IRS regulations, a partner can meet the deficit capital account restoration requirement by giving the partnership a personal promissory note upon liquidation. The note itself is treated as satisfying the contribution obligation (in lieu of a current cash contribution or debt assumption) provided that three qualifications are met. One of the qualifications listed in the regulations is that the note must be negotiable.]

    b. The note must pledge to restore both his economic and tax-basis capital account. [This answer is incorrect. The capital accounts that must be restored under the economic effect rules are the economic capital accounts—these capital accounts may have nothing to do with tax-basis capital accounts. Therefore, Edmund would not have to make this pledge to meet the deficit capital account restoration requirement.]

    c. He must contribute the FMV of the note to the partnership within the required period. [This answer is incorrect. Under the regulations, to use a promissory note, Edmund must contribute to the partnership, within the required period, the excess of the principal balance of the note over its FMV at the time of liquidation. (The principal of the note is deemed to equal the note's FMV, provided the interest rate on the note is not less than the applicable federal rate at the time of valuation.)]

    d. He must contribute the note by 90 days after liquidation. [This answer is incorrect. According to the IRS regulations, Edmund can use a promissory note if it is contributed within the time required (i.e., the later of year-end or 90 days after liquidation).]

14. Assume all of the following individuals are partners in partnerships relying on the safe harbor rules. Each of these partners has a deficit capital account upon liquidation. Which of these partners would cause the partnership to fail the economic effect test? **(Page 115)**

    a. Under the partnership agreement, Emily's deficit restoration is limited to a fixed dollar amount that is less than the deficit in her account. [This answer is correct. If a partner does not have a deficit restoration obligation or if he has only a partial deficit restoration obligation (i.e., limited to a fixed dollar amount), allocations of economic loss that create a negative capital account in excess of what the partner is obligated to restore (if anything) do not pass the economic effect test under the regulations. The losses are required to be allocated among the partners who actually bear the economic risk relating to the losses.]

    b. The payment Fred makes to restore his capital account is distributed to the other partners in his partnership. [This answer is incorrect. According to the regulations, any payment made to restore a negative capital account can be distributed to the other partners according to their positive capital accounts no later than at the time of liquidation of their partnership interests.]

    c. George assumes partnership debt in the amount of his deficit account and pays the amount to the creditor. [This answer is incorrect. Under the regulations, any payment made to restore a negative capital account can be paid to partnership creditors. This requirement to pay creditors is not a creditor relief provision, and restoration of a capital account by payment to creditors can be accomplished if the partner assumes the partnership's debt owed to the creditor.]

    d. Hannah is a limited partner not required to restore her deficit capital account, but her partnership agreement includes a qualified income offset provision. [This answer is incorrect. While, according to the regulations, a partner who is not required to restore a negative book capital account cannot be allocated economic losses that would cause his book account to become negative, a partner's capital account can nevertheless become negative because of items other than economic loss allocations. The qualified income offset provision is intended to correct for such items that cause a negative book capital account.]

15. The Lincoln Partnership has a limited partner who is not required to restore a negative capital account. The partnership agreement includes a qualified income offset provision. Which of the following is a special adjustment that the partnership must make to the limited partner's account so the partnership allocations will still qualify under the substantial economic effect safe harbor? **(Page 118)**

    a. The account must be credited in advance for allocations of cash-basis items. [This answer is incorrect. When making special adjustments under the regulations, the limited partner's book capital account would be reduced in advance, not credited. One special adjustment listed in the regulations is a reduction of the account for allocations of tax loss and deduction sunder IRC Sec. 706(d) (allocations of cash-basis items when partner's interest changes).]

    b. The account must be reduced in advance for all oil and gas profits. [This answer is incorrect. Under the regulations, the limited partner's account would be reduced specifically for certain oil and gas percentage depletion allowances, not profits.]

    c. The account must be reduced in advance for tax loss allocations on Section 751 inventory distributions. [This answer is correct. Under the IRS regulations, the limited partner's account would be reduced in advance for five items, to the extent that they are reasonably expected to occur in the current tax year and in future tax years. One of those items is allocations of tax loss recognized by the partnership on a distribution of Section 751 unrealized receivables or inventory.]

    d. No allocations of economic loss can be made to a limited partner. [This answer is incorrect. Under the regulations, if a series of special adjustments have been made to the limited partner's capital account and that capital account is now negative (by an amount in excess of the partner's obligation to restore a deficit), no further allocations of economic loss can be made to the partner. But prior to that point, economic loss can be allocated to the limited partner.]

16. When would a partnership allocation be deemed insubstantial? **(Page 119)**

    a. If, after taxes and on a present-value basis, the allocation benefits at least one partner, but there is no substantial cost to the other partners. [This answer is correct. According to the IRS regulations, an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement (1) the after-tax economic consequences of at least one partner, in present value terms, may be enhanced compared to the partner's after-tax consequences if the allocation were not contained in the partnership agreement, and (b) there is a strong likelihood that no partner's after-tax economic consequences will, in present value terms, be substantially diminished compared to that partner's consequences if the allocation were not contained in the partnership agreement.]

    b. If it is inconsistent with the underlying economic arrangement of the partners. [This answer is incorrect. Under the safe harbor rules, the consistency of a tax allocation with the partners' underlying economic arrangement is one of the measures of the allocation's economic effect.]

    c. If it exceeds 100% of the amount of income, gain, loss, and deduction allocated to a partner for tax purposes. [This answer is incorrect. According to the regulations, this would be a violation of the ceiling rule. The ceiling rule limits a partnership's ability to allocation income, gain, loss, and deduction, but it is not part of the substantial economic effect safe harbor test.]

    d. If the partnership agreement is not specially amended for the allocations after the events creating them occurred. [This answer is incorrect. In Rev. Rul. 99-43, the IRS ruled that partnership special allocations lacked substantiality under Reg. 1.704-1(b)(2)(iii) when the partnership agreement was amended to specially allocate items after the events creating them had not occurred, and the overall economic effect of the allocations on the partners' capital accounts did not differ substantially from the economic effect of the original allocations in the agreement.]

17. The Rosewater Partnership makes an allocation. Upon closer examination, the net increases and decreases in the book capital accounts of the partners are substantially what they would have been if this allocation had not been made. After the allocation, the partners' total tax liability is less than if the allocation was not contained in the partnership agreement. What is this an example of? **(Page 120)**

    a. An insubstantial allocation. [This answer is incorrect. While this type of allocation would be presumed insubstantial, that is not necessarily the case. This presumption can be overcome by a showing of facts and circumstances that prove it is not insubstantial.]

    b. A shifting allocation. [This answer is correct. Under the IRS regulations, the allocation described above is a shifting allocation. There are two criteria that must exist for an allocation to have a shifting tax consequence, and the allocation made by the Rosewater Partnership has both of them.]

    c. A transitory allocation. [This answer is incorrect. The Rosewater Partnership did not make a transitory allocation, as this type of allocation is defined in the regulations.]

    d. A tiered ownership structure. [This answer is incorrect. It is possible under the regulations for the tiered ownership structure of a partnership to affect whether its tax allocations are substantial. However, that is not the consideration described above.]

18. The Jefferys-Mathews Partnership has a transitory allocation; however, at the time the allocation became part of the partnership agreement, there was a strong likelihood any offsetting allocations would not be made within five years of the original allocation. How would this allocation be classified? **(Page 122)**

    a. Substantial. [This answer is correct. This is a safe harbor for chargebacks from sources other than sales of property found in the regulations. Because of the five year qualification, the allocation in this scenario would be considered substantial.]

    b. Insubstantial. [This answer is incorrect. Generally, a transitory allocation would be treated as insubstantial; however, the specific circumstances described above mitigate that finding.]

19. Zach is a member of the Cousin Partnership. The partnership agreement is amended to include a special allocation; however, Zach disagrees with this allocation. What action can Zach take in this situation? **(Page 124)**

    a. Because the allocation is added to the partnership agreement, Zach has no choice but to file his tax return the same way as the other partners in the Cousin Partnership. [This answer is incorrect. There is nothing to prevent a partner from challenging the income tax effect of a special allocation. Even if the special allocation is added to the partnership agreement, the objecting partner is not required by the regulations or the Internal Revenue Code to file consistently with that allocation.]

    b. Zach can file his tax return consistent with his interpretation of the allocation, even if that differs from the partnership return and his Schedule K-1. [This answer is correct. If a partner rejects a special allocation, the partner should file his or her individual tax return in the manner described in this answer choice. A partner who does file inconsistently should notify the Service of the inconsistency as required by IRC Sec. 6222(b).]

BOOK CAPITAL ACCOUNTS MAINTAINED UNDER THE SAFE HARBOR RULES

For a tax allocation to fall within the substantial economic effect safe harbor, it must be consistent with economic allocations made under the book capital account maintenance rules. For partnerships that want their tax allocations to be within the safe harbor, compliance with these economic capital account maintenance provisions is mandatory.

Understanding Rules for Maintaining Accounts

Generally, the rules for maintaining capital accounts are the same for purposes of both the safe harbor rules and for determining the partners' interests in the partnership. The partners' interests in the partnership and the safe harbor rules were discussed previously in this course.

Under the Section 704(b) regulations, increases in a partner's economic, or book, capital account are made for:

a. the amount of money contributed to the partnership,

b. the FMV (not adjusted tax basis) of property contributed to the partnership reduced by the liabilities secured by the property or assumed by the partnership as part of the contribution, and

c. allocations of economic (not tax) income and gain to the partner.

Decreases in the partner's book capital account are made for:

a. the amount of money distributed to the partner,

b. the FMV of property (net of liabilities) distributed to the partner, and

c. the partner's allocable share of partnership economic losses and deductions.

Since these book capital accounts are economic accounts, the treatment of the applicable income or loss for tax purposes is irrelevant in determining book capital accounts. For example, tax-exempt income and nondeductible losses, which represent economic income and loss, are treated the same for book capital account purposes as items of economic income and loss that are includable in computing taxable income.

The regulations provide detailed instructions on treatment of many specific items for determining the partners' book capital accounts. Where guidance is lacking, the capital account adjustments must be made in a manner that:

a. maintains equality between the aggregate capital accounts of the partners and the amount of capital reflected on the partnership's book balance sheet,

b. is consistent with the underlying economic arrangement of the partners, and

c. is based, wherever practicable, on federal tax accounting principles.

Minor discrepancies between the balances in the partner's respective book capital accounts and the balances that would be in those accounts if they were maintained precisely as required by Reg. 1.704-1(b)(2)(iv) do not adversely affect the validity of an allocation, provided that the discrepancies are minor and are attributable to good faith errors by the partnership. The regulations do not define what constitutes a *minor discrepancy*.

Each partner is treated as having only one book capital account, even though the partner may have different types of partnership interests—for example, general and limited interests—or may have acquired multiple interests on different days and for different amounts.

Upon transfer of a partnership interest, the transferee takes over the transferor's book capital account. There is no revaluation of the capital accounts (as might otherwise occur if the transferee had obtained his interest by making

a capital contribution. Book capital accounts of the partners are carried over when there is a Section 708(b)(1)(B) technical termination.

Client Profile Illustrating Application of the Capital Account Maintenance Rules

Larry and Bob each contribute $1,250 cash to a general partnership. The partnership uses $500 in Year One to pay for currently deductible items. There is no other Year One income or loss. The partnership agreement allocates profits and losses 50% to each partner. All allocations are reflected in the partners' book capital accounts, and liquidating distributions are required to be made according to the partners' positive capital account balances. Each partner has a qualifying deficit capital account restoration obligation and the allocations are substantial at the time the partnership agreement is entered into.

In Year Two the partnership purchases depreciable property for $2,000 using the remaining cash. Assume the property is depreciated using the straight-line method over five years for both tax and economic (book) purposes. The partnership leases the property to a third party, and in Year Two the rental income equals its operating expenses. Thus, the Year Two net tax and book loss is $400 from depreciation.

Because Larry needs tax deductions and Bob does not, they agree to amend the partnership agreement to provide that all losses will be allocated to Larry. Future profits will be allocated 100% to Larry until he reports income in an amount equal to any losses that were previously allocated to him. Thereafter, losses will be allocated 50/50. Liquidating distributions will also be divided equally.

Under the economic agreement between the partners at the beginning of Year Two, the $400 loss in Year Two is allocated 100% to Larry, with the following result:

	Larry Book	Bob Book	Partnership Book
Beginning capital	$ 1,000	$ 1,000	$ 2,000
Year Two loss	(400)	—	(400)
Ending capital	$ 600	$ 1,000	$ 1,600

There is a conflict between the agreement for allocating losses and the agreement for distributing liquidation proceeds. After allocating the Year Two losses 100% to Larry, his book capital account shows a balance of $600, while Bob's is $1,000. To be within the safe harbor capital account maintenance rules, liquidation proceeds would have to be distributed according to these book capital account balances. However, the partnership agreement provides that liquidation proceeds are divided equally (i.e., $800 to each partner if the partnership were liquidated at the end of Year Two).

It must first be determined which provision of the agreement controls: the loss allocation provision or the liquidation provision. This is a question of local law, but generally it is assumed that the liquidation provision is the more specific provision at the time of liquidation, and thus it controls. Assuming that the liquidation provision controls, the partnership agreement does not provide for liquidation according to the partners' book capital accounts, and therefore, allocation of 100% of the losses to Larry does not have substantial economic effect.

As is often the case, Larry and Bob assumed the asset would not actually depreciate and, thus, it would be worth $2,000 or more at the end of Year Two. The depreciation allocation was assumed to be only for tax purposes and without any real economic impact. If the property was sold for $2,000 or more, Larry would receive an additional $400 of the tax gain on the sale as a chargeback for the extra loss allocation he received. Then, the distribution of liquidation proceeds would be made according to capital accounts.

Even if Larry and Bob could establish beyond any doubt that their assumption was correct, the allocation still fails the substantial economic effect test because the test mandates the assumption that assets are sold for book value, not some higher or lower value. A chargeback provision does not fix a defective loss allocation (see Example 2-14 for more on chargebacks). The regulations, which assume that all book losses represent real economic losses, mandate that the partner receiving the loss allocation also must bear the economic burden of that loss (with a similar analysis for profit allocations).

Since the desired loss allocation does not have economic effect, the loss must be reallocated between the partners to reflect the partners' real economic interests in the partnership. Since the partnership agreement controls, the economic losses are reallocated 50/50 among the partners to reflect their equal distribution rights as follows:

	Larry Book	Bob Book	Partnership Book
Beginning capital	$ 1,000	$ 1,000	$ 2,000
Year Two loss	(200)	(200)	(400)
Ending capital	$ 800	$ 800	$ 1,600

Now that the economic allocations accurately reflect the partners' real economic interests in the partnership (50/50), the tax allocations are made in the most consistent manner, as follows:

	Larry		Bob		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 2,000	$ 2,000
Year Two loss	(200)	(200)	(200)	(200)	(400)	(400)
Ending capital	$ 800	$ 800	$ 800	$ 800	$ 1,600	$ 1,600

The desired 100% allocation of Year Two tax losses to Larry does not comply with the safe harbor allocation provisions, which would require a 50/50 allocation of both economic (book) and tax losses as shown. Example 2-1 shows how a partner can be allocated 100% of partnership losses if that partner is willing to pay the economic price of the special allocation.

Applying Selected Specific Book Capital Account Maintenance Rules

Section 709 Expenditures. Expenditures that are not deductible for tax purposes as a result of IRC Sec. 709 [for example, organization and syndication fees, except to the extent organization fees are deducted or amortized under IRC Sec. 709(b)] are required to be deducted from the book capital accounts of the partners. This book capital account reduction is not paralleled by a corresponding reduction of the partner's outside partnership tax basis.

Basis Adjustments to Section 38 Property. The downward adjustment of tax basis in Section 38 property pursuant to taking a tax credit, and the recovery of that basis on disposition of the property, are matched by a corresponding economic loss or gain, and book capital accounts are adjusted down or up, accordingly. No capital account adjustment is made with respect to taking the credit; the capital account adjustment relates only to the basis reduction and recovery.

Section 754 Elections. Elections under IRC Sec. 754 result in the adjustment of partnership property's tax basis after the sale or exchange of a partnership interest or the recognition of gain or loss as a result of a distribution of partnership property. These adjustments are to tax basis and are not economic adjustments. Therefore, tax basis adjustments pursuant to elections under IRC Sec. 754 generally do not result in book capital account adjustments. Although the regulations require the partnership to account for an optional basis adjustment on its tax return, they confirm that optional basis adjustments are not reflected in the partner's book capital accounts. There is one exception to this general rule, which is discussed and illustrated in the following two paragraphs.

Liquidating Distribution to a Partner. When a liquidating distribution is made to a partner, the partnership has an option to revalue the book capital accounts of all the partners. (Revaluing capital accounts is discussed later in this course.) After revaluation, the book capital accounts of each partner reflect the current value of that partner's share of partnership assets. If the election to revalue is not made, and the partner receives a liquidating distribution at a time when his book capital account does not reflect the full value of his share of partnership assets, the resulting capital account may wind up artificially high or low.

In an effort to avoid this problem, regulations provide that when the partnership adjusts the tax basis of its assets upon making a liquidating distribution to a partner the distributee partner's book capital account is adjusted by the amount of the partnership's tax basis adjustment. The basis adjustment can be reflected in the book capital account of the distributee partner only to the extent that the adjustment exceeds the difference between the book value of partnership property and the adjusted tax basis of the property (prior to the Section 754 adjustment). This prevents a double book-up in a situation where the partnership has previously booked up the value of the property on its balance sheet.

Example 2-16: Revaluing book capital accounts of the partners upon a liquidating distribution.

Amy is a one-third partner in ABC Partnership. The partnership has $100 cash and an appreciated capital asset with a $200 FMV and an $80 tax basis. The appreciated property's FMV is not reflected in the partners' book capital accounts. The FMV of Amy's interest is $100 and her tax basis and book capital account are both $60. The partnership makes a distribution of $100 cash to Amy in liquidation of her partnership interest. Because of the distribution, Amy recognizes a $40 tax gain on the liquidation. The partnership's balance sheet before it makes the distribution is as follows:

ABC Partnership
Balance Sheet Prior to Distribution

	Tax Basis	FMV
Cash	$ 100	$ 100
Capital asset	80	200
Total assets	$ 180	$ 300
Capital		
Amy	$ 60	$ 100
Brian	60	100
Clark	60	100
Total capital	$ 180	$ 300

If the partnership makes an election to revalue all partnership property for book capital account purposes at the time of the distribution, Amy's capital account is increased to $100 immediately prior to the distribution, and the distribution of cash reduces her book capital account to zero. The capital accounts of the other partners are also revalued to $100.

If the partnership does not revalue the partners' book capital accounts and the partnership has made a Section 754 election, the partnership increases the tax basis of the capital asset by $40 and Amy's book capital account is also increased by the amount of the adjustment (i.e., $40). Amy's ending book capital account is zero after the $100 cash distribution. For tax purposes the partnership tax basis in the capital asset is increased under IRC Sec. 734(b) because of the Section 754 election. The election has no effect on Amy's outside tax basis, even though it triggers an adjustment to her book capital account.

If the partnership does not revalue the partners' capital accounts, and the partnership has not made a Section 754 election, Amy's book capital account is reduced to negative $40. This is a recognized anomaly in the calculation of capital accounts under the regulations, and Amy is not required to restore the negative capital account, as the negative capital account does not reflect the economic agreement of the partners.

Guaranteed Payments under IRC Sec. 707(c). Guaranteed payments to a partner under IRC Sec. 707(c) cause the recipient partner's book capital account to be adjusted only to the extent of such partner's distributive share of any partnership deduction or loss (or other adjustment) resulting from the guaranteed payment. The payment itself is not a distribution for purposes of adjusting the partner's book capital account, but is instead a payment in the nature of compensation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Partners of the Weatherford-Stone Partnership want partnership tax allocations to fall within the substantial economic effect safe harbor. How will their book capital accounts be affected?

    a. The accounts must be maintained in accordance with the partners' interests in the partnership.

    b. The accounts must be maintained under the economic capital account maintenance provisions.

    c. Tax allocations must be made specifically according to the tax regulations.

    d. Capital account adjustments must always be made based on federal tax accounting principles.

21. Assume the same details as in the scenario above. Which of the following would be true for the Weatherford-Stone Partnership?

    a. Minor discrepancies can exist in the book capital accounts without affecting the validity of an allocation.

    b. If a partnership interest is transferred, capital accounts must be revalued.

    c. If there is a Section 708(b)(1)(B) technical termination, the book capital accounts must be revalued.

    d. Tax-exempt income is treated differently from economic income in the book capital accounts.

22. The Meta Partnership makes a liquidating distribution to a partner. Can it revalue its book capital accounts?

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. Partners of the Weatherford-Stone Partnership want partnership tax allocations to fall within the substantial economic effect safe harbor. How will their book capital accounts be affected? **(Page 133)**

    a. The accounts must be maintained in accordance with the partners' interests in the partnership. [This answer is incorrect. Making allocations consistently with the partners' interests in the partnerships is a broader, more general alternative that using the safe harbor rules.]

    b. The accounts must be maintained under the economic capital account maintenance provisions. [This answer is correct. For a tax allocation to fall within the substantial economic effect safe harbor, it must be consistent with economic allocations made under the book capital account maintenance rules found in the IRS regulations. For partnerships that want their tax allocations to be within the safe harbor, compliance with these economic capital account maintenance provisions is mandatory.]

    c. Tax allocations must be made specifically according to the tax regulations. [This answer is incorrect. The book capital accounts are economic accounts, so the treatment of applicable income or loss for tax purposes is irrelevant in determining book capital accounts, according to the regulations.]

    d. Capital account adjustments must always be made based on federal tax accounting principles. [This answer is incorrect. The regulations provide detailed instructions on treatment of many specific items for determining the partners' book capital accounts. Where guidance is lacking, the capital account adjustments must be made in a manner that, in addition to other things, is based, whenever practicable, on federal tax accounting principles.]

21. Assume the same details as in the scenario above. Which of the following would be true for the Weatherford-Stone Partnership? **(Page 133)**

    a. Minor discrepancies can exist in the book capital accounts without affecting the validity of an allocation. [This answer is correct. Under the regulations, minor discrepancies between the balances in the partner's respective book capital accounts and the balances that would be in those accounts if they were maintained precisely as required by Reg. 1.704-1(b)(2)(iv) do not adversely affect the validity of an allocation, provided that the discrepancies are minor and are attributable to good faith errors by the partnership. The regulations do not define was constitutes a *minor discrepancy*.]

    b. If a partnership interest is transferred, capital accounts must be revalued. [This answer is incorrect. According to the regulations, upon transfer of a partnership interest, the transferee takes over the transferor's book capital account. There is no revaluation of the capital accounts (as might otherwise occur if the transferee had obtained his interest by making a capital contribution).]

    c. If there is a Section 708(b)(1)(B) technical termination, the book capital accounts must be revalued. [This answer is incorrect. According to the regulations, book capital accounts of the partners are carried over when there is a Section 708(b)(1)(B) technical termination.]

    d. Tax-exempt income is treated differently from economic income in the book capital accounts. [This answer is incorrect. Under the regulations, tax-exempt income and nondeductible losses, which represent economic income and loss, are treated the same for book capital account purposes as items of economic income and loss that are includable in computing taxable income.]

22. The Meta Partnership makes a liquidating distribution to a partner. Can it revalue its book capital accounts? **(Page 135)**

    a. **Yes. [This answer is correct. Under the regulations, when a liquidating distribution is made to a partner, the partnership has the option to revalue the book capital accounts of all the partners. After revaluation, the book capital accounts of each partner reflect the current value of that partner's share of partnership assets.]**

    b. No. [This answer is incorrect. This option is allowed under the regulations; however it is not mandatory. If the election to revalue is not made, and the partner receives a liquidating distribution at a time when his book capital account does not reflect the full value of his share of partnership assets, the resulting capital account may wind up artificially high or low. The regulations provide a method that can be used under the safe harbor rules to avoid this problem.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TPSTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

6. Which of the following statements accurately compares or contrasts the substantial economic effect safe harbor rules with another set of accounting rules?

   a. A partnership's tax allocations must have substantial economic effect and also be made in accordance with the partners' interests in the partnership.

   b. The safe harbor rules are completely consistent with generally accepted accounting principles (GAAP), as they serve the same purpose.

   c. GAAP is concerned with presenting a financial picture of a business over time; the safe harbor rules address partners' rights regarding partnership liquidation value.

   d. The safe harbor rules provide a system of bookkeeping that can be used for partnerships that make allocations based on the partners' interests in the partnership.

7. Which of the following partnerships pass the safe harbor substantial economic effect test?

   a. The Rocky Partnership has substantial economic and tax allocations.

   b. The Peak Partnership makes all allocations in accordance with the partners' interests in the partnership.

   c. The Sierra Partnership has economic allocations with economic effect, and corresponding tax allocations are made consistently with the economic allocations.

   d. The Mountain Partnership has substantial economic allocations that have economic effect. The partnership's corresponding tax allocations are also substantial and are made consistently with the economic allocations.

8. The Parka Partnership uses the partners' interests in the partnership method for making allocations. Which of the following would the IRS consider when determining the interests of each partner in the partnership?

   i. The relative contributions of each partner to the partnership.

   ii. The substantial economic effect of partnership transactions.

   iii. The partners' interests in the partnership's cash flow and other nonliquidating distributions.

   iv. The partnership agreement.

   v. The partners' interests in the partnership's economic profits and losses.

   vi. The partners' rights to distributions of capital if the partnership liquidates.

   a. i., ii., and iv.

   b. i., iii., v., and vi.

   c. i., iii., iv., v., and vi.

   d. i., ii., iii., iv., v., and vi.

9. The Pennies Partnership exists in a state that adopted the federal tax rules, including the regulations at IRC Sec. 704(b), but retains a specific difference in how much depreciation is allowable for a specific asset in any year. Can the partnership meet safe harbor rules for both state and federal tax purposes if it has depreciable property that falls into this category?

   a. Yes—it must create different book capital accounts for state and federal purposes.

   b. No—it must analyze other options.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

10. Define the concept of economic effect under the safe harbor rules.

   a. The partners' underlying economic arrangement is maintained and accounted for by the capital account maintenance rules in the regulations, and the partnership's tax allocations are consistent with this arrangement.

   b. A reasonable possibility exists that the partnership's allocations will, independent of tax considerations, substantially affect the dollar amounts that the partners will receive.

   c. A partner cannot be allocated income, gain, loss, or deduction that exceeds 100% of the amount for that item that the partnership actually recognizes for tax purposes.

   d. The excess amount of any nonrecourse liabilities secured by partnership property over the collateral property's book basis.

11. If the Fishery Partnership follows the capital account rules spelled out in the economic effect regulations, it will dictate to the partners how certain profits and losses are to be shared. What options, if any, do the partners have if they would prefer not to use these allocations?

   a. Though they are tax regulations, the economic effect regulations are mandatory requirements; thus, the partnership has no choice but to comply.

   b. The partnership can make allocations that are inconsistent with the economic effect regulations if those allocations conform to the partners' interests in the partnership.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

12. Norma and Hal each contribute $2,500 to the Broom Partnership. The partnership uses $1,000 in its first year to pay for currently deductible items, and there is no other income or loss for the year. Profits and losses are allocated 50% to each partner, according to the partnership agreement. The partnership agreement provides that book capital accounts will be accounted for under the safe harbor rules, and includes all necessary provisions. Calculate the amount of ending book and tax capital each partner and the partnership will have at the end of the year.

   a. Norma: $2,000; Hal: $2,000; Partnership: $2,000.

   b. Norma: $1,000; Hal: $3,000; Partnership: $4,000.

   c. Norma: $3,000; Hal: $1,000; Partnership: $4,000

   d. Norma: $2,000; Hal: $2,000; Partnership: $4,000.

13. Which of the following partnerships is in compliance with the deficit capital restoration requirement of the safe harbor rules?

    a. The Albert Partnership is a limited partnership formed specifically to limit investors' liability for making additional contributions.

    b. The Baker Partnership liquidates at the end of its tax year. Partners with a negative capital account must restore their balances within the next 180 days.

    c. The Connell Partnership's partnership agreement relies on local law to define the time limit of its deficit capital account restoration requirement.

    d. Upon liquidation, partners of the Delaney Partnership are allowed to use personal promissory notes to meet the deficit capital account restoration requirement.

14. The Pinkerton Partnership has several limited partners who are not required to contribute any funds beyond their initial contributions. These partners are not required to restore a deficit capital account. Pinkerton's partnership agreement meets the first two elements of the economic effect test. Before allocating losses, Pinkerton makes special adjustments to these partners' book accounts according to the regulations. The partnership agreement also includes a qualified income offset provision. Will Pinkerton still qualify under the substantial economic effect safe harbor?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

15. When dealing with a qualified income offset provision, which of the following circumstances would likely be considered unexpected by the partnership?

    a. The Igloo Partnership holds funds in the partnership account that are pending distribution.

    b. The Junker Partnership is a limited partnership with promoters that guarantee minimum distributions to investor partners.

    c. The King Partnership has an indefinite plan to refinance a piece of partnership property and distribute the proceeds once the property has appreciated in value.

    d. The Lakeside Partnership allows partners to make contributions to increase their capital accounts so losses can be allocated to the partners with the understanding that the partners' contributions will be returned.

16. How is the substantiality test related to the economic effect test under the safe harbor rules?

    a. To be recognized, allocations that fail the economic effect test must pass the substantiality test.

    b. To be recognized, allocations that fail the substantiality test must pass the economic effect test.

    c. To be recognized, allocations must pass both the economic effect test and the substantiality test.

    d. Both tests primarily consist of economic analysis of partnership allocations.

17. The Baker's Dozen Partnership has four equal partners. Betty and Donna are direct partners in Baker's Dozen. The other two partners are Oven Partners (a general partnership owned equally by Callie and Eden) and Cookie Corp. (an S corporation wholly owned by Jodie). When determining if the book allocations of Baker's Dozen have substantial effect, allocations of items to whom must be considered?

    a. Betty and Donna.

    b. Jodie, Callie, and Eden.

    c. Betty, Donna, and Jodie.

    d. Betty, Donna, Callie, Eden, and Jodie.

18. The Hoffman-Kline Partnership makes an allocation that will be largely offset by an allocation that the partners know will occur in a future year. There is a strong likelihood that, at that time, the net increases and decreases in the partners' book capital accounts will be substantially the same as if the offsetting allocations had not been made. Also, there is a strong likelihood that the partners' total tax liability will be less than if the allocations had not been made. What is this an example of?

    a. A transitory allocation.

    b. A shifting allocation.

    c. An insubstantial allocation.

    d. A substantial allocation.

19. What is the most specific term for an allocation of income or loss that is matched by an offsetting allocation in a later year?

    a. A shifting allocation.

    b. A chargeback allocation.

    c. A special allocation.

    d. A transitory allocation.

20. When a partnership relying on the safe harbor rules maintains its accounts, determine whether each of the following would increase or decrease partners' book capital accounts.

    i. Amounts of money distributed to the partner.

    ii. Amounts of money contributed to the partnership.

    iii. Property FMV (net of liabilities) that is distributed to the partner.

    iv. The partner's share of the partnership's economic losses and deductions.

    v. Economic (not tax) income and gain that are allocated to the partner.

    vi. Property FMV (not the adjusted tax basis) contributed to the partnership that is reduced by the liabilities that the property secures or that are assumed by the partnership as part of that contribution.

    a. Increases—i., ii., and iii.; Decreases—iv., v., and vi.

    b. Increases—i., iii., and iv.; Decreases—ii., v., and vi.

    c. Increases—ii., v., and vi.; Decreases—i., iii., and iv.

    d. Increases—ii., iv., and vi.; Decreases—i., iii., and v.

21. If a partner has multiple types of partnership interest in the same partnership, how many book capital accounts can he or she have under the safe harbor rules?

    a. One.

    b. Two.

    c. Three.

    d. The partner can have as many book capital accounts as he or she has types of partnership interest.

22. Which of the following would generally require no adjustment to a partnership's book capital account?

    a. Section 709 expenditures.

    b. A basis adjustment to Section 38 property.

    c. Section 754 elections.

    d. Do not select this answer choice.

Lesson 3: Allocations under Other Special Circumstances

INTRODUCTION

This lesson discusses the rules for making allocations of partnership gain and loss in other special circumstances. Topics covered include mandatory and optional revaluations of book capital accounts, limitations of the ceiling rule, Section 704(c) allocations, allocations of losses and deductions that are attributed to nonrecourse liabilities, allocations related to contributed property, allocations of credits, and allocations of foreign taxes.

The topics covered in this lesson will help accountants prepare to advise their clients on how to structure such allocations in their partnerships so that the IRS will not object to the transaction. The examples included in the text will help put the IRS regulations into meaningful terms and provide possibilities for best practices.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify when mandatory and optional book capital account revaluations should be made and their consequences to the partnership.
- Summarize the ceiling rule and rules for Section 704(c) allocations, and compare and contrast the allocation methods that are available.
- Recognize allocations associated with nonrecourse liabilities, contributed property, credits, and foreign taxes.

MANDATORY AND OPTIONAL REVALUATIONS OF BOOK CAPITAL ACCOUNTS

Identifying When Mandatory Revaluations Are Made

When property (other than money) is contributed to or distributed by a partnership, the book capital account of the contributing or distributee partner and the partnership's book basis in partnership assets must be adjusted based on the FMV of the property.

In the case of a property distribution, the property may have been carried on the partnership books at a value other than its FMV. For book capital account purposes, distributed property is treated as if it is first sold for its FMV, the corresponding book gain or loss is recognized and allocated to the partners per the partnership agreement (with appropriate adjustments of book capital accounts), and then the property's FMV is treated as distributed. The gain or loss deemed to be recognized is for book capital account purposes only. There is no tax recognition of gain or loss, as there has been no realization or recognition event for tax purposes.

Upon a distribution of partnership property, the revaluation of the distributed property to its current FMV for book capital account purposes is mandatory under the safe harbor rules (it seems likely that the same would also be true under the partners' interests in the partnership rules).

Identifying When Optional Revaluations Can Be Made

In four situations under the safe harbor capital account maintenance rules, there is the opportunity to make an optional revaluation of all partnership property (not just contributed or distributed property) for book capital account purposes, provided that the revaluation is for substantial nontax purposes. The four situations are:

a. A contribution of property (including money) to the partnership in exchange for a partnership interest.

b. A distribution of property (including money) from a partnership in exchange for a partnership interest (the distribution does not have to be in liquidation of the partner's entire interest).

c. Under generally accepted industry accounting practices where substantially all of the partnership's property (excluding money) is stock, securities, commodities, options, warrants, futures, or similar instruments that are readily traded on an established securities market.

d. The grant of a partnership interest (other than a *de minimis* interest) to an existing or new partner in exchange for services provided to or for the benefit of the partnership. Note that this provision is only effective for partnership interests granted after May 5, 2004. When applicable, this rule permits revaluations even when the partner receiving the interest does not contribute any property to the partnership. In particular, this provision facilitates the granting of profits-only interests in exchange for services by permitting adjustments to the capital accounts of the other partners (i.e., those not receiving interests in exchange for services) in order to reflect changes in the values of partnership assets. Immediately after such a revaluation, the capital account associated with the newly granted profits-only interest would generally have an initial book value of zero (which is usually the desired outcome).

Under the safe harbor rules, the optional revaluation of partnership assets for book capital account purposes may occur only under one of the preceding four circumstances. Such a revaluation may be appropriate at other times under the partners' interests in the partnership rules.

The language providing for the revaluation of property in these situations may be included in the original partnership agreement or in an amendment to the partnership agreement (filed before the due date for filing the partnership tax return, without extensions, for the tax year for which the revaluation is effective). No written election is required to be attached to the tax return of the partnership or the partners.

Example 3-1: Electing to revalue partnership property upon the admission of a new partner.

ABC Partnership has one nondepreciable asset which has a $300 FMV and a $150 tax basis. The three equal partners, Arnold, Bill, and Clay, each have book capital accounts and tax bases in their partnership interests of $50. New partner Dave contributes $100 cash to the partnership in exchange for a 25% interest. The FMV and tax basis of the property Dave contributed are equal, so IRC Sec. 704(c) would not normally apply. Dave's contribution presents an opportunity to make an optional revaluation of all partnership property. The partnership's balance sheet before Dave's admission is as follows:

ABC Partnership
Pre-contribution Balance Sheet

	FMV	Tax	Book
Nondepreciable asset	$ 300	$ 150	$ 150
Capital:			
Arnold	$ 100	$ 50	$ 50
Bill	100	50	50
Clay	100	50	50
Total capital	$ 300	$ 150	$ 150

If the partnership makes the election to revalue, the book value of the existing partnership asset is increased to $300—its FMV at the time of the adjustment. For purposes of adjusting the book capital accounts of Arnold, Bill, and Clay, the asset is treated as if it is sold for $300 with the partnership recognizing economic (not tax) gain of $150, which is allocated $50 to each of the three original partners. Their book capital accounts are thereby increased to $100 each. The property's tax basis remains at $150 (thus there is a $150 book/tax difference—the difference between the $300 book value and the $150 tax basis), and the partnership tax basis of Arnold, Bill, and Clay remains at $50 each. Dave's book capital account and tax basis are both $100. The post-contribution balance sheet is as follows:

ABC Partnership
Post-contribution Balance Sheet

	FMV	Tax	Book
Cash	$ 100	$ 100	$ 100
Nondepreciable asset	300	150	300
Total assets	$ 400	$ 250	$ 400
Capital:			
Arnold	$ 100	$ 50	$ 100
Bill	100	50	100
Clay	100	50	100
Dave	100	100	100
Total capital	$ 400	$ 250	$ 400

If the property continues to appreciate and is eventually sold for $400, there is a $100 book gain and a $250 tax gain. The book gain is allocated $25 to each of the four partners. The first $150 of the tax gain is allocated $50 each to Arnold, Bill, and Clay, reconciling the book/tax difference, and the last $100 of tax gain is allocated $25 each to the four partners (in the manner most consistent with the underlying economic allocation). The ending book capital accounts (and tax basis) of the partners would be $125 each, reflecting their relative distribution rights to the $500 cash now held by the partnership.

Example 3-2: Deciding not to revalue property upon the admission of a new partner.

Assume the same facts as the preceding example. If the partnership does not elect to revalue the asset, the book capital accounts of Arnold, Bill, and Clay remain at $50 each, while Dave's book capital account is $100. Assume again that the property is sold for $400, resulting in a book and tax gain of $250. In this case, the only way to reconcile the economic gain on sale with the partners' underlying agreement (i.e., that they are all equal) is to allocate the first $150 of economic gain $50 each to Arnold, Bill, and Clay and the second $100 of gain equally to the four partners. The tax gain is allocated in the same manner so that the ending book capital accounts and tax basis of all of the partners is $125 each. The result is the same as if the election had been made.

Knowing the Procedures to Follow for Revaluation

If the partnership elects to revalue all partnership assets for book capital account purposes, the procedures for revaluation are as follows:

a. The adjustments are based on the property's FMV on the revaluation date.

b. The property is treated as sold, and book gain or loss is recognized for book capital account purposes by subtracting the property's book capital account basis from the FMV of the property.

c. The book gain or loss is allocated among the partners on the basis of the economic arrangements in the partnership agreement.

d. Book depreciation, amortization, depletion, and subsequent book gain or loss upon disposition of the revalued property must be calculated as provided in the safe harbor regulations.

e. While a book/tax difference created by revaluation does not affect the amount of tax depreciation, amortization, depletion, and gain or loss, it does affect the allocation of these tax items. Such allocations must reflect the differences between tax basis and book value under Section 704(c) principles. The same is true for income and loss from receivables and payables.

While optional revaluations are not required, the regulations contemplate that the election usually will be made, since in most situations making the election causes the partners' book capital accounts to most nearly reflect the

economic agreement among the partners. If the election to revalue is not made, the partnership agreement must effectively provide the same results as if the election had been made. Otherwise, the regulations caution, there may be tax ramifications outside of the allocation arena (for example, a gift or compensation). The partnership's election to revalue all of the partnership assets has economic implications to the partners and is not merely a technical exercise.

The partnership must make allocations with respect to the revalued property using a reasonable method that is consistent with the purposes of IRC Sec. 704(b) and (c). The three methods specifically mentioned in the regulations for making these allocations are the traditional method, the traditional method with curative allocations, and the remedial allocation method.

Client Profile Illustrating the Impact of Revaluing Capital Accounts

Steve and Dan form a partnership in 2008 in which they each contributed $10,000. The partnership purchased raw land with this $20,000. At the beginning of 2009, the land is worth $40,000, and George contributes $20,000 to enter the partnership as an equal one-third partner. The $20,000 is used to buy an additional parcel of land. Prior to George's entry into the partnership, the tax basis and book capital accounts of Steve and Dan were $10,000 each (reflecting the original tax basis and economic value of their contributions). The partnership agreement complies with the safe harbor regulations.

If the partnership elects to revalue partnership assets and partners' capital accounts, all assets held by the partnership are treated for book capital account purposes as if sold for their FMV, and the resulting book gain or loss is allocated to the partners under the partnership agreement. (In this context, the FMV of the partnership assets is generally easy to determine, as the partners will usually value the assets in determining the interests that the new partners are receiving for their contributions.) This recognition of gain/loss is for book capital account purposes only, and there is no current tax gain or loss recognized. The tax basis of the property and of each partner's partnership interest is unaffected by the revaluation of the property. Therefore, the revaluation results in a book/tax difference which must subsequently be reconciled. [The reconciliation of this difference is known as a *reverse Section 704(c) allocation*.]

If the partnership does not elect to adjust the book capital accounts of all the partners, it must somehow account for the partners' different interests in the partnership assets when they are sold. This is generally done through a special allocation of book and tax gain on the sale of the partnership assets. Failure to account for the book/tax disparity by either revaluing book capital accounts or some other acceptable means raises the issue of whether the transaction involves a disguised gift, compensation payment, or some similar item.

To see the effect of revaluation versus no revaluation, assume that on the first day of 2010 (with the book capital accounts of the partners unchanged from what they were immediately after George's entry), the partnership sells all of the land for $90,000. As the tax basis of each property is $20,000 (total of $40,000), this results in a $50,000 tax gain. The amount and allocation of the book gain depends on whether the partnership made the election to revalue partnership assets upon George's entry.

Calculating Gain on Sale When an Election to Revalue Was Made. Assume the partnership elected to revalue all its assets and the partners' book capital accounts upon George's admission to the partnership. Since the property was revalued at the time of George's admission in 2009, the property's book value is increased to $60,000, and thus the book gain on sale is only $30,000 ($90,000 − $60,000). The tax gain is $50,000 ($90,000 − $40,000). The partners' book capital accounts are equal after George's entry (reflecting their equal interests in the partnership), but the revaluation of Steve's and Dan's capital accounts causes a book/tax difference at the end of 2009. The difference is reconciled upon the sale of the property in 2010 by allocating the excess tax gain to Steve and Dan as follows:

2008

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Contribution	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ —	$ —	$ 20,000	$ 20,000
Ending capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ -0-	$ -0-	$ 20,000	$ 20,000

2009

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ —	$ —	$ 20,000	$ 20,000
Contribution	—	—	—	—	20,000	20,000	20,000	20,000
Revaluation	10,000	—	10,000	—	—	—	20,000	—
Ending capital	$ 20,000	$ 10,000	$ 20,000	$ 10,000	$ 20,000	$ 20,000	$ 60,000	$ 40,000

2010 SALE

	Partnership	
	Book	Tax
Sale results:		
Sale price	$ 90,000	$ 90,000
Less basis	(60,000)	(40,000)
Gain	$ 30,000	50,000
Less book gain		(30,000)
Excess tax gain		$ 20,000

2010 GAIN ALLOCATIONS

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 20,000	$ 10,000	$ 20,000	$ 10,000	$ 20,000	$ 20,000	$ 60,000	$ 40,000
Excess tax gain	—	10,000	—	10,000	—	—	—	20,000
Book = tax gain	10,000	10,000	10,000	10,000	10,000	10,000	30,000	30,000
Ending capital	$ 30,000	$ 30,000	$ 30,000	$ 30,000	$ 30,000	$ 30,000	$ 90,000	$ 90,000

Figuring the Gain on Sale If There Is No Election to Revalue. Now, assume the partnership elects not to revalue. The book capital accounts of Steve and Dan would each remain at $10,000 at the time of George's admission. The partnership agreement would allocate the first $20,000 of book and tax gain 50% each to Steve and Dan, and all additional book and tax gain would be allocated one-third to each partner as follows:

2008

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Contribution	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ —	$ —	$ 20,000	$ 20,000
Ending capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ -0-	$ -0-	$ 20,000	$ 20,000

2009

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ —	$ —	$ 20,000	$ 20,000
Contribution	—	—	—	—	20,000	20,000	20,000	20,000
Ending capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 20,000	$ 20,000	$ 40,000	$ 40,000

2010 SALE

	Partnership	
	Book	Tax
Sale results:		
Sale price	$ 90,000	$ 90,000
Less basis	(40,000)	(40,000)
Gain	$ 50,000	50,000
Less book gain		(50,000)
Excess tax gain		$ -0-

2010 GAIN ALLOCATIONS

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 20,000	$ 20,000	$ 40,000	$ 40,000
Special gain	10,000	10,000	10,000	10,000	—	—	20,000	20,000
Regular gain	10,000	10,000	10,000	10,000	10,000	10,000	30,000	30,000
Ending capital	$ 30,000	$ 30,000	$ 30,000	$ 30,000	$ 30,000	$ 30,000	$ 90,000	$ 90,000

This is the same result as achieved with a revaluation. In situations where the contributed nondepreciable property or existing nondepreciable partnership property has *built-in* gain, there are no economic differences caused by the decision to revalue or not revalue if the property at least holds its value after contribution (as shown by the above examples). The reverse is true for loss property held by the partnership at the time of the revaluation.

Calculating Loss on Sale When an Election to Revalue Was Made. Consider, however, the results if the property is sold for a book loss. Assume in the above example, the partnership property depreciates and is sold for $33,000 at the beginning of 2010.

If the partners elected to revalue upon George's admission, the results of the sale are as follows (ending 2009 book and tax accounts are the same as under "Figuring Gain on Sale When an Election to Revalue Was Made"):

2010 SALE

	Partnership	
	Book	Tax
Sale results:		
Sale price	$ 33,000	$ 33,000
Less basis	(60,000)	(40,000)
Loss	(27,000)	$ (7,000)
Less tax loss	(7,000)	
Excess book loss	$ (20,000)	

2010 LOSS ALLOCATIONS

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 20,000	$ 10,000	$ 20,000	$ 10,000	$ 20,000	$ 20,000	$ 60,000	$ 40,000
Book loss	(9,000)	—	(9,000)	—	(9,000)	—	(27,000)	—
Tax loss	—	—	—	—	—	(7,000)	—	(7,000)
Ending capital	$ 11,000	$ 10,000	$ 11,000	$ 10,000	$ 11,000	$ 13,000	$ 33,000	$ 33,000

Because the capital accounts have been revalued, the book loss impacts the partners equally, and on liquidation they each receive $11,000, per their book capital account balances. All of the tax loss is allocated to George, because that allocation causes book and tax ending capital accounts to be as close as possible. Allocating any of the tax loss to Steve and Dan would increase the book/tax difference. Because of the ceiling rule (discussed later in this lesson), there is insufficient tax loss to allocate George the full amount of losses ($9,000) to which he is entitled. Therefore, on liquidation of the partnership, Steve and Dan each recognize a $1,000 capital gain, and George recognizes a $2,000 capital loss.

Figuring the Loss on Sale If There Is No Election to Revalue. Compare the above allocations with the allocations that result when the partnership does not elect to revalue upon George's admission. Assuming a sale for the same $33,000, the results are as follows (ending 2009 book and tax accounts are the same as previously under "Figuring the Gain on Sale If There Is No Election to Revalue"):

2010 SALE

	Partnership	
	Book	Tax
Sale results:		
Sale price	$ 33,000	$ 33,000
Less basis	(40,000)	(40,000)
Gain (Loss)	(7,000)	$ (7,000)
Less tax loss	(7,000)	
Excess book loss	$ -0-	

2010 LOSS ALLOCATIONS

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 20,000	$ 20,000	$ 40,000	$ 40,000
Book = tax loss	(2,333)	(2,333)	(2,333)	(2,333)	(2,334)	(2,334)	(7,000)	(7,000)
Ending capital	$ 7,667	$ 7,667	$ 7,667	$ 7,667	$ 17,666	$ 17,666	$ 33,000	$ 33,000

For sales producing a loss, the economic and tax results are dramatically different depending on whether or not the book capital accounts are revalued upon George's admission. While the original partners, Steve and Dan, received $11,000 each in the prior example where capital accounts were revalued, they only receive $7,667 each when the election to revalue is not made. If the book capital accounts are not revalued, only the partners who have interests in the unrealized appreciation (i.e., the original partners) bear the risk of loss on the unrealized gain. If the capital accounts are revalued, all partners bear the risk of loss in proportion to their book loss interests (one-third each in this case). The reverse would be the case if the original property had unrealized loss potential. A special allocation to George of the first $10,000 of loss can alleviate part of the problem, by fully eliminating the differential between the partners if the partnership is lucky enough to lose at least the full $10,000. With such a special allocation, the $7,000 loss would produce the following results:

2010 LOSS ALLOCATIONS (ALTERNATE)

	Steve		Dan		George		Partnership	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 20,000	$ 20,000	$ 40,000	$ 40,000
Book = tax loss	—	—	—	—	(7,000)	(7,000)	(7,000)	(7,000)
Ending capital	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 13,000	$ 13,000	$ 33,000	$ 33,000

Although it is not obvious without the type of analysis shown above, the issue of whether or not to revalue partnership property upon the entry of a new partner can have significant economic and tax results depending on fluctuations in value that occur after the new partner's admission. Therefore, partners and tax advisors should not rely on boilerplate language in partnership agreements without a clear understanding of the impact that such language may have on the economics of the deal.

Similarly, if revaluations are optional under the partnership agreement, the decision to revalue partnership property should not be made lightly and the method and authority for the decision should be clearly delineated.

There are opportunities to revalue property and structure gain and loss allocations to protect the interests of both the original partners and new partners so as to avoid *unfair* economic and tax results when asset values fluctuate.

Client Profile Illustrating the Impact on Tax Depreciation of Revaluing Capital Accounts

Steve and Dan form a partnership at the beginning of 2010. Steve contributes $10,000 cash, and Dan contributes a piece of depreciable equipment with a $6,000 tax basis. The cost recovery method is straight-line with a remaining five-year life. The partnership has income equal to operating expenses other than depreciation. The partnership agreement complies with the safe harbor regulations and, except as otherwise provided in this example, provides for a 50/50 split of all partnership items.

Steve and Dan disagree on the value of the property contributed by Dan. Dan claims it is worth $10,000. Steve feels the value is not that much, but agrees that it is not less than $6,000, the property's tax basis. Steve, however, is willing to agree to the $10,000 value, provided that the property is ultimately sold for at least $10,000.

The remaining tax cost recovery period and method of cost recovery for the property contributed by Dan is five years, straight-line (or $1,200 per year). To be within the safe harbor rules, the partnership must also use five years,

straight-line for book purposes. Thus, if the partners agree that the book value of the property contributed by Dan is $10,000, the annual book depreciation expense will be $2,000. If they agree that the value is $6,000, the annual book depreciation will be $1,200. Other options may be available under the partners' interest in the partnership method.

Since tax allocations are controlled by book allocations (see Example 2-5), if there is a book/tax difference, the tax allocations must be made in a manner that reconciles the book/tax difference as quickly as possible. Under the traditional method prescribed by the Section 704(c) regulations, this requires an allocation to the partner who does not have any book/tax difference (usually the cash partner in the deal) of an amount of taxable income or deduction equal to the book income or deduction received by that partner. See the discussion of Section 704(c) allocations later in this course. The balance of tax depreciation (if any) is then allocated to the partner who has a book/tax difference (the partner contributing the property).

While this client profile involves a partnership formation and the contribution of property that has a book value different than its tax basis, the same book/tax difference problems can arise as a result of a partnership deciding whether to revalue its assets under the optional revaluation of capital account rules. For example, assume that a number of partners hold a property in an existing partnership and Steve becomes a new partner (or increases his existing partnership interest) by contributing cash to the partnership. The options for handling book capital accounts in the two situations (a contribution of property that creates a book/tax difference or an optional revaluation of partnership assets under the regulations) are the same.

Electing to Revalue the Contributed Property. If the partners agreed to value the property contributed by Dan at $10,000, the annual book losses over the first five years would be $2,000 per year allocated $1,000 to each partner. The book capital account results in the first year are:

	Steve Book	Dan Book	Partnership Book
Contributions	$ 10,000	$ 10,000	$ 20,000
2010 loss	(1,000)	(1,000)	(2,000)
Ending capital	$ 9,000	$ 9,000	$ 18,000

Once the book capital account allocations are properly determined, the tax allocations can be made. The partner without the book/tax difference (Steve) is allocated tax depreciation equal to his book depreciation. The balance (if any) is allocated to the partner with the book/tax difference (Dan) as follows:

	Steve		Dan		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 10,000	$ 10,000	$ 10,000	$ 6,000	$ 20,000	$ 16,000
2010 loss	(1,000)	(1,000)	(1,000)	(200)	(2,000)	(1,200)
Ending capital	$ 9,000	$ 9,000	$ 9,000	$ 5,800	$ 18,000	$ 14,800

This procedure eventually eliminates the book/tax difference over the asset's life by allocating more tax depreciation to Steve and less to Dan as shown in the following illustration:

	Steve		Dan		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 10,000	$ 10,000	$ 10,000	$ 6,000	$ 20,000	$ 16,000
2010 loss	(1,000)	(1,000)	(1,000)	(200)	(2,000)	(1,200)
Ending capital	9,000	9,000	9,000	5,800	18,000	14,800
2011 loss	(1,000)	(1,000)	(1,000)	(200)	(2,000)	(1,200)
Ending capital	8,000	8,000	8,000	5,600	16,000	13,600
2012–14 losses	(3,000)	(3,000)	(3,000)	(600)	(6,000)	(3,600)
Ending capital	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 10,000	$ 10,000

If the partnership is liquidated at the end of 2014 (and assuming the equipment has no residual value), the $10,000 cash would be distributed $5,000 to each of the partners per their book capital accounts (which are then identical to their tax basis capital accounts).

Deciding Not to Revalue the Contributed Property. If, however, the partners agreed the FMV of Dan's contributed asset was only $6,000 (coupled with a special allocation of the first $4,000 of gain to Dan), the allocation of tax depreciation is dramatically different. In that case, the book depreciation is $1,200 per year, which is shared equally by the partners per their economic agreement. The partners share the tax depreciation equally. The results for the first five years are:

	Steve		Dan		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Contributions	$ 10,000	$ 10,000	$ 6,000	$ 6,000	$ 16,000	$ 16,000
2010 loss	(600)	(600)	(600)	(600)	(1,200)	(1,200)
Ending capital	9,400	9,400	5,400	5,400	14,800	14,800
2011 loss	(600)	(600)	(600)	(600)	(1,200)	(1,200)
Ending capital	8,800	8,800	4,800	4,800	13,600	13,600
2012–14 losses	(1,800)	(1,800)	(1,800)	(1,800)	(3,600)	(3,600)
Ending capital	$ 7,000	$ 7,000	$ 3,000	$ 3,000	$ 10,000	$ 10,000

Valuing Dan's contributed property at $6,000 protected Steve from a loss of up to $2,000 (50% of the book/tax difference on the contributed property). However, that loss protection resulted in a shift of tax depreciation away from Steve to Dan.

The total annual tax depreciation is $1,200 irrespective of the economic value of Dan's contributed property; however, the annual book depreciation is $1,200 if the property is valued at $6,000 and $2,000 if the property is valued at $10,000. Under their partnership agreement the annual book depreciation, whatever it is, is allocated 50% each to Steve and Dan. Steve (the noncontributing partner) is then allocated tax depreciation equal to his share of economic depreciation, and Dan is allocated the balance. Also, note that Steve's allocation of tax depreciation equal to his book depreciation allocation is limited by the ceiling rule. (Discussed later in this course.) Thus, when the property is valued at $10,000 and Steve is allocated $1,000 in book depreciation each year, he is allocated $1,000 of tax depreciation as well. Dan receives the balance of the tax depreciation, $200, even though he also has a $1,000 book depreciation allocation. When, however, the property is valued at $6,000 for book purposes and Steve is allocated $600 of book depreciation, he receives only a matching amount of tax depreciation, and Dan is also allocated $600 of book and tax depreciation.

Reconciling Book/Tax Differences

Book/tax differences must generally be reconciled by following the principles of IRC Sec. 704(c). These rules require the allocation of book and tax depreciation, depletion, or amortization in the manner that most quickly reduces the book/tax difference. When a book/tax difference exists, book depreciation, depletion, and amortization are computed based on tax depreciation, depletion, and amortization amounts. Under the safe harbor capital account maintenance rules, the amount of book depreciation, amortization, or depletion for a period must have the

same relationship to the book basis of a property as the tax depreciation, amortization, or depletion has to the tax basis of that property. Because of the often unfavorable results of computing book depreciation, amortization, and depletion under the safe harbor regulations, partners may want to use capital account procedures that are at odds with the safe harbor requirement, and rely instead on the rules governing the partners' interests in the partnership. [The former version of Reg. 1.704-1(b)(2)(iv)(g)(3) allowed greater latitude concerning the calculation of book depreciation, amortization, and depletion. The approaches allowed by the former regulation, and other approaches, may, under the proper circumstances, still be valid under the partners' interests in the partnership rules.]

The decision to make an optional revaluation of partnership property and the decision to use the safe harbor rules or some other approach (under the partners' interests in the partnership rules) for handling book depreciation, amortization, and depletion can have a significant economic impact on the partners. Therefore, these are not decisions that are made only for tax purposes.

Avoiding Use of Boilerplate Language

It is a very common practice in partnership agreements to require that capital accounts be maintained "according to Reg. 1.704-1(b)(2)(iv);" in other words, under the safe harbor rules. This boilerplate provision generally may be acceptable, but in some circumstances it can significantly affect the economic arrangement among the partners. Also, such boilerplate language does not address many important issues—such as whether or not the partnership will make optional revaluations. Often, the decisions that can have the greatest economic impact are not mandated by the partnership agreement. For example, the decision to follow the safe harbor rules for computing book depreciation, amortization, and depletion or to use some other method (under the partners' interests in the partnership approach) should be agreed to by the partners and should not be handled by boilerplate language in the agreement.

Identifying Reverse Section 704(c) Allocations

An optional revaluation of partnership property will likely result in a difference between the value of the partnership property for book capital account purposes and the partnership's adjusted tax basis in that property. This so-called book/tax difference is reconciled under principles consistent with IRC Sec. 704(c) (which technically apply only to property contributions when there are differences between FMV and tax basis at the time of contribution). (See the discussion later in this course.) This type of allocation is known as a reverse Section 704(c) allocation. Partnerships are not required to use the same allocation method for reverse Section 704(c) allocations as for contributed property, even if the property is already subject to IRC Sec. 704(c). Furthermore, partnerships are not required to use the same allocation method for reverse Section 704(c) allocations each time the partnership revalues its property. A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of IRC Sec. 704(b) and (c).

Client Profile Illustrating the Different Allocation Methods for Making Reverse Section 704(c) Allocations for Built-in Gains

Jim and Joe form J&J Partnership, a 50/50 partnership. Jim contributed vacant land with a $10,000 FMV and a $6,000 tax basis. Joe contributed $10,000 cash. J&J elects to allocate the built-in Section 704(c) gain using the traditional method. The balance sheet for J&J at formation is:

	FMV	Adjusted Basis
Asset		
Cash	$ 10,000	$ 10,000
Land	10,000	6,000
Total	$ 20,000	$ 16,000

	FMV	Adjusted Basis
Capital		
Jim	$ 10,000	$ 6,000
Joe	10,000	10,000
Total	$ 20,000	$ 16,000

Later in the year, Jake joins the partnership by contributing $25,000 for a 50% capital and profits interest. At that time the land has appreciated in value to $15,000. Under IRC Sec. 704(b) the partnership can elect to revalue the book capital accounts of Jim and Joe to reflect the unrealized appreciation in the land that occurred before Jake joined. [This is a reverse Section 704(c) allocation.]

Using the Remedial Method to Make Allocations. The following illustrates the partner's capital accounts immediately after Jake joins the partnership. Note that Jim and Joe's capital accounts are adjusted to reflect the $5,000 of unrealized appreciation in the land that has occurred since it was contributed to the partnership prior to Jake's admission.

	Jim		Joe		Jake		J&J	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
Beginning capital	$ 10,000	$ 6,000	$ 10,000	$ 10,000	$ —	$ —	$ 20,000	$ 16,000
Contribution	—	—	—	—	25,000	25,000	25,000	25,000
Revaluation	2,500	—	2,500	—	—	—	5,000	—
Total	$ 12,500	$ 6,000	$ 12,500	$ 10,000	$ 25,000	$ 25,000	$ 50,000	$ 41,000

In the following year, the value of the land dropped and J&J sells it for $11,000 recognizing a book loss of $4,000 ($11,000 sales proceeds − $15,000 book value) and a tax gain of $5,000 ($11,000 sales proceeds − $6,000 tax basis). J&J can use any method to make its reverse Section 704(c) allocation even though the partnership elected to use the traditional method to allocate the Section 704(c) built-in gain on the land Jim contributed. Assume J&J elects to use the remedial allocation method when revaluing the book capital accounts and making the reverse Section 704(c) allocation. The book loss is allocated $2,000 to Jake and $1,000 each to Jim and Joe, which is in line with their capital and profits interests. Since Jake was allocated $2,000 for book purposes, under the remedial allocation method selected for the reverse Section 704(c) allocation, he would also receive a $2,000 tax loss. Jim and Joe each receive $1,000 offsetting remedial allocations, which total $2,000. In addition, Jim is allocated a $4,000 tax gain, which is the remaining built-in gain on the property ($10,000 FMV − $6,000 tax basis). (Since the real property was not subject to depreciation, the built-in gain did not change from the time of contribution.) The remaining $1,000 tax gain ($5,000 total tax gain − $4,000 allocated to Jim) is allocated $500 each to Jim and Joe. This amount represents the remaining appreciation that was accounted for when Jim and Joe's capital accounts were revalued when Jake joined the partnership. Jim recognizes a total tax gain of $5,500, Joe recognizes a $1,500 tax gain, and Jake has a tax loss of $2,000, netting to a total partnership gain of $5,000. The following illustrates both book and tax allocations upon the sale of the land.

	Jim		Joe		Jake		J&J	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
2009 ending capital	$ 12,500	$ 6,000	$ 12,500	$ 10,000	$ 25,000	$ 25,000	$ 50,000	$ 41,000
Book loss	(1,000)	—	(1,000)	—	(2,000)	—	(4,000)	—
Remedial allocation	—	1,000	—	1,000	—	(2,000)	—	—
Tax gain	—	4,500	—	500	—	—	—	5,000
2010 ending capital	$ 11,500	$ 11,500	$ 11,500	$ 11,500	$ 23,000	$ 23,000	$ 46,000	$ 46,000

Now assume that the property is sold for $8,000. There is a book loss of $7,000 ($8,000 sales proceeds − $15,000 book value) and a $2,000 tax gain ($8,000 sales proceeds − $6,000 tax basis). The book loss is allocated $3,500 to Jake and $1,750 each to Jim and Joe. Once again, remedial allocations are made with a tax loss of $3,500 to Jake and offsetting tax gains to Jim and Joe of $1,750. This time Jim is allocated the entire $2,000 tax gain, which represents the remaining built-in gain at the time of contribution. Due to the ceiling rule, Jim is the only partner to receive an allocation of the actual tax gain. Taking into account the remedial allocation, Jim recognizes a total tax gain of $3,750, Joe recognizes a total tax gain of $1,750, and Jake recognizes a tax loss of $3,500. The partner's aggregate tax gains total $2,000. The partners' capital accounts reflecting this sale is shown below:

	Jim		Joe		Jake		J&J	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
2009 ending capital	$ 12,500	$ 6,000	$ 12,500	$ 10,000	$ 25,000	$ 25,000	$ 50,000	$ 41,000
Book loss	(1,750)	—	(1,750)	—	(3,500)	—	(7,000)	—
Remedial allocation	—	1,750	—	1,750	—	(3,500)	—	—
Tax gain	—	2,000	—	—	—	—	—	2,000
2010 ending capital	$ 10,750	$ 9,750	$ 10,750	$ 11,750	$ 21,500	$ 21,500	$ 43,000	$ 43,000

Using the Traditional Method to Make Allocations. Assume the same facts except the partnership uses the traditional method for both allocations. There is a $4,000 book loss and a $5,000 tax gain. There are no remedial allocations for the book loss. Everything else is the same. Jim is still allocated $4,500 of tax gain, which represents his $4,000 built-in gain that remains from contribution and half of the remaining $1,000 gain. The $1,000 gain, which is allocated to Jim and Joe, represents a portion of the unrealized gain for which their book capital accounts were revalued at the time that Jake joined the partnership. Jake recognizes no tax gain or loss. This is the result of the ceiling rule not allowing any additional amounts in excess of the total gain recognized to be allocated. The total partnership gain remains at $5,000 just as in the original set of facts.

	Jim		Joe		Jake		J&J	
	Book	Tax	Book	Tax	Book	Tax	Book	Tax
2009 ending capital	$ 12,500	$ 6,000	$ 12,500	$ 10,000	$ 25,000	$ 25,000	$ 50,000	$ 41,000
Book loss	(1,000)	—	(1,000)	—	(2,000)	—	(4,000)	—
Tax gain	—	4,500	—	500	—	—	—	5,000
2010 ending capital	$ 11,500	$ 10,500	$ 11,500	$ 10,500	$ 23,000	$ 25,000	$ 46,000	$ 46,000

As can be seen from the preceding paragraphs, a partnership can use different methods for Section 704(c) allocations and reverse Section 704(c) allocations with different results. This is a very complicated area and when the assets are depreciable, depletable, or amortizable, it becomes even more complicated. Care should be taken when determining what methods should be used not only for Section 704(c) allocations but also any reverse Section 704(c) allocations.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. The Snowflake Partnership distributes a piece of property. The property was carried on partnership books at a value other than its FMV. The property is treated as if sold for its FMV, and then corresponding book gain is recognized and allocated to the partners as per the partnership agreement. What type of revaluation is this?

    a. Mandatory.

    b. Optional.

24. The Trio Partnership has one nondepreciable asset with a FMV of $600 and a tax basis of $300. There are three equal partners—Reba, Susie, and Tawnie—with book capital accounts and tax bases in their partnership interests of $100. Una contributes $200 cash to the partnership for a 25% interest. The FMV and tax basis of the contributed property are equal. The partners elect to make an optional revaluation of all partnership property. Calculate the amount the three original partners each will have in their book capital account after the revaluation.

    a. $100.

    b. $200.

    c. $300.

    d. $800.

25. Using the facts from the previous question, assume that the Trio Partnership elects not to revalue its assets when Una becomes a partner. Later, partnership assets are sold. Which of the following actions would be the best option for the partnership?

    a. The partnership should elect an optional revaluation at the time of the sale.

    b. The partnership should not make any adjustments to book capital accounts.

    c. The partnership should make a special allocation of book and tax gain on the sale of the property.

26. When reconciling book/tax differences, which rules would generally give partnerships computing book depreciation the most favorable results?

    a. The safe harbor rules.

    b. Partners' interests in the partnership rules.

27. If a partnership makes a reverse Section 704(c) allocation, must it use the same allocation method as it did for contributed property?

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. The Snowflake Partnership distributes a piece of property. The property was carried on partnership books at a value other than its FMV. The property is treated as if sold for its FMV, and then corresponding book gain is recognized and allocated to the partners as per the partnership agreement. What type of revaluation is this? **(Page 145)**

    a. Mandatory. [This answer is correct. At the conclusion of the mandatory revaluation described in this scenario, the property's FMV is treated as distributed, according to the IRS regulations. The gain or loss deemed to be recognized is for book capital accounts only. There is no tax recognition of gain or loss, as there has been no realization or recognition event for tax purposes.]

    b. Optional. [This answer is incorrect. Four specific situations exist for optional revaluations under the safe harbor capital account maintenance rules. This is not one of them.]

24. The Trio Partnership has one nondepreciable asset with a FMV of $600 and a tax basis of $300. There are three equal partners—Reba, Susie, and Tawnie—with book capital accounts and tax bases in their partnership interests of $100. Una contributes $200 cash to the partnership for a 25% interest. The FMV and tax basis of the contributed property are equal. The partners elect to make an optional revaluation of all partnership property. Calculate the amount the three original partners each will have in their book capital account after the revaluation. **(Page 146)**

    a. $100. [This answer is incorrect. Due to the book/tax difference, this is the amount that Reba, Susie, and Tawnie have in their tax basis account, not their book capital account.]

    b. $200. [This answer is correct. After the optional revaluation, the three original partners, and the new partner, as well, will have $200 in their book capital accounts. The asset would be treated as if it were sold for $600, with the partnership realizing a gain of $300 that is distributed between Reba, Susie, and Tawnie to bring their book capital accounts up to $200, which matches Una's account.]

    c. $300. [This answer is incorrect. This is the book/tax difference after the partnership's property is revalued. This is also the total amount of gain recognized by the partnership in the revaluation.]

    d. $800. [This answer is incorrect. This is the total capital of the partnership after the revaluation.]

25. Using the facts from the previous question, assume that the Trio Partnership elects not to revalue its assets when Una becomes a partner. Later, partnership assets are sold. Which of the following actions would be the best option for the partnership? **(Page 148)**

    a. The partnership should elect an optional revaluation at the time of the sale. [This answer is incorrect. This type of optional revaluations can only be done under certain circumstances outlined in the regulations. This would not be an option in the scenario described above.]

    b. The partnership should not make any adjustments to book capital accounts. [This answer is incorrect. While this would be an option for the partnership, it would not be the best option. According to the regulations, Failure to account for the book/tax disparity by either revaluing book capital accounts or some other acceptable means raises the issue of whether the transaction involves a disguised gift, compensation payment, or some similar item.]

    c. The partnership should make a special allocation of book and tax gain on the sale of the property. [This answer is correct. According to the regulations, if the partnership does not elect to adjust the book capital accounts of all the partners, it must somehow account for the partners' different interests in the partnership assets when they are sold. This is generally done through a special allocation of book and tax gain on the sale of the partnership assets.]

26. When reconciling book/tax differences, which rules would generally give partnerships computing book depreciation the most favorable results? **(Page 154)**

    a. The safe harbor rules. [This answer is incorrect. The former version of Reg. 1.704-1(b)(2)(iv)(g)(3) allowed greater latitude concerning the calculation of book depreciation, amortization, and depletion. However, under the current safe harbor rules, the results of computing book depreciation would generally be less favorable.]

    b. Partners' interests in the partnership rules. [This answer is correct. Because of the often unfavorable results of computing book depreciation, amortization, and depletion under the safe harbor regulations, partners may want to use capital account procedures that are at odds with the safe harbor requirement, and rely instead on the rules governing the partners' interests in the partnership.]

27. If a partnership makes a reverse Section 704(c) allocation, must it use the same allocation method as it did for contributed property? **(Page 155)**

    a. Yes. [This answer is incorrect. This is not a requirement of the regulations. A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of IRC Sec. 704(b) and (c).]

    b. No. [This answer is correct. Under the regulations, partnerships are not required to use the same allocation method for reverse Section 704(c) allocations as for contributed property, even if the property is already subject to IRC Sec. 704(c). Furthermore, partnerships are not required to use the same allocation method for reverse Section 704(c) allocations each time the partnership revalues its property.]

LIMITATIONS OF THE CEILING RULE

An important limitation on a partnership's ability to allocate income, gain, loss, and deduction among the partners is the ceiling rule. Simply stated, the ceiling rule provides that the amount of income, gain, loss, and deduction that can be allocated to a partner for tax purposes cannot exceed 100% of the amount of such item that the partnership actually recognizes for tax purposes.

Because of the ceiling rule, in some circumstances a partner cannot be allocated tax items equal to the corresponding economic profit or loss realized by that partner.

Example 3-3: Recognizing how the ceiling rule limits the tax allocation of gain.

Assume Adam and Betty form a partnership with Adam contributing $1,000 cash and Betty contributing a nondepreciable asset with a $1,000 FMV and a $600 tax basis. Adam and Betty have equal economic interests in partnership profits and losses.

Under the safe harbor book capital account rules, they each have opening book capital accounts of $1,000. Assume the asset decreases in value to $900, and the partnership sells it. The partnership has a $100 economic loss, but it has a $300 tax gain. The economic loss is allocated $50 to each partner, thereby reducing their book capital accounts to $950 each. It appears that the proper way to treat the tax allocations is to allocate Betty a $350 tax gain and Adam a $50 tax loss. This allocation gives each partner a $950 ending tax basis, matching their ending book capital accounts. However, the ceiling rule limits the total tax allocation of gain to $300, all of which is allocated to Betty.

As a result, Betty's ending tax basis is $900, and Adam's ending tax basis is $1,000. If the partnership liquidates, Betty recognizes a $50 gain and Adam a $50 loss (because the liquidating distributions are based on their ending book capital accounts of $950 each).

Example 3-4: Recognizing how the ceiling rule affects tax depreciation allocations.

Assume the same facts as in the previous example, except the tax basis of the property Betty contributed is $400. The property is depreciable. The remaining tax depreciation is straight-line over five years, and the book depreciation follows the safe harbor requirements (same period and method as tax—straight-line over five years). The total economic depreciation each year is $200, but the total annual tax depreciation is only $80. The book depreciation is allocated $100 each to Adam and Betty

Under both IRC Sec. 704(c) and the safe harbor rules of IRC Sec. 704(b), Adam is required to receive all of the tax depreciation up to the amount of his economic depreciation ($100 per year), with the balance (zero in this case) being allocated to Betty. There is insufficient tax depreciation in any one year ($80) or over the total life of the property ($400) to allocate Adam tax losses equal to his economic losses either annually ($100) or over the property's life ($500). The maximum that can be allocated to Adam (and the amount that must be allocated to Adam) is $80 per year.

Assuming the partnership uses the traditional method for making Section 704(c) allocations, when the property is fully depreciated (and assuming that it is sold for zero dollars, its book value), Betty's ending book capital account and tax basis are $500 and $400, respectively, while Adam's are $500 and $600, respectively. Thus, Adam recognizes a tax loss upon liquidation ($600 tax basis less $500 received) while Betty recognizes a $100 gain ($500 received less $400 tax basis).

Because of the ceiling rule, in some cases (as shown in the two preceding examples), the final book capital accounts will not reconcile to the final tax basis capital accounts. The regulations under IRC Sec. 704(c) provide a method to avoid this result by using curative allocations of other items of partnership income and expense. See the discussion of these rules later in this course.

ALLOCATIONS MADE UNDER IRC SEC. 704(c)

IRC Sec. 704(c)(1)(A) provides that partnership taxable income, gain, loss, and deduction must be allocated among the partners to take into account the differences between the FMV of property contributed to a partnership

and the tax basis at the time of contribution; i.e., book/tax differences relating to contributed property must be reconciled.

There is no difference between the book/tax reconciliation rule as required by IRC Sec. 704(c) and that required by the regulations under IRC Sec. 704(b). Technically, IRC Sec. 704(c), by its terms, applies only to contributed property and the Section 704(b) regulations apply to book/tax differences in all other circumstances. But the same book/tax difference problems arise in both contexts. Consequently, the rules are the same under IRC Secs. 704(b) and (c). The Section 704(b) regulations rely heavily on cross-reference to the Section 704(c) regulations regarding the rules for reconciling book/tax differences. The Section 704(c) regulations require the application of Section 704(c) principles to reconcile book/tax differences created by a revaluation.

The regulations provide that when a partner contributes property with a FMV different from the contributing partner's basis, the partnership can use any reasonable method to make allocations so that the contributing partner receives the tax burdens and benefits of the precontribution gain or loss. Partnerships can use one of the three specific methods described in the regulations for making allocations under IRC Sec. 704(c), or any other reasonable method. The three specific methods discussed in the regulations are the traditional method, the traditional method with curative allocations, and the remedial allocation method. An exception to the application of the Section 704(c) rules for small disparities is discussed later in this lesson.

Aggregating Property for Making Allocations

Property generally cannot be aggregated for purposes of making allocations under IRC Sec. 704(c). However, each of the following types of property can be aggregated:

a. Property, other than real property, that is included in the same general asset account of the contributing partner and the partnership.

b. Property, other than real property, with a basis equal to zero.

c. Inventory, other than securities or similar investments, if the partnership does not use the specific identification method of accounting.

In addition, for purposes of making reverse Section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach consistent with IRC Sec. 704(c). Generally, once an aggregation method is adopted, that same method must be applied to all qualified financial assets in all tax years that the partnership is considered a Section 704(c) securities partnership.

A partnership is a securities partnership if it is (a) either a management company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 or (b) an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts, except for reasonable special allocations to a partner who provides management services or investment advisory services to the partnership. An investment partnership is defined as a partnership that (a) holds qualified financial assets that constitute at least 90% of the FMV of the partnership's non-cash assets on the date of each capital account restatement; and (b) reasonably expects, as of the end of the first tax year in which the partnership adopts an aggregate approach, to make revaluations at least annually.

Rev. Proc. 2007-59 allows qualified partnerships to aggregate gains and losses from an expanded list of qualified financial assets. A qualified financial asset is generally any personal property actively traded as defined in Reg. 1.1092(d)-1. Reg. 1.704-3(e)(3)(ii) lists additional qualified financial assets for management companies.

In Ltr. Rul. 200051019, the IRS permitted a securities partnership to aggregate securities for purposes of making Section 704(c) and reverse Section 704(c) allocations. The partnership was also allowed to aggregate built-in gains and losses from contributed property with built-in gains and losses from revaluations. However, the partnership was required to stipulate that such aggregation did not result in tax allocations made with a view to shifting the tax consequences of built-in gain and loss among the partners in a manner that substantially reduced the value of the partners' aggregate tax liability.

Rev. Proc. 2010-3 specifies that securities partnerships in qualified master-feeder structure arrangements can obtain automatic IRS permission to aggregate securities for purposes of making Section 704(c) allocations and reverse Section 704(c) allocations with respect to their securities holdings. The IRS will no longer issue letter rulings with respect to allocation issues covered by Rev. Proc. 2010-3. See Rev. Proc. 2001-36 for a definition of qualified master-feeder structures.

Being Aware of the Anti-abuse Rule

An allocation method will not be considered reasonable if the contribution and the allocations with respect to the contributed property are made with the intent to shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. This generally will occur when the ceiling rule is used to shift the tax burden associated with built-in gain to the noncontributing partner. If the anti-abuse rule is invoked, the IRS can make curative allocations to reduce the tax effect of the abusive allocation method. However, Reg. 1.704-3(d)(5)(ii) specifically provides that the IRS cannot require the partnership to use the remedial allocation method, which permits the allocation of notional tax items. Alternatively, the IRS may choose to invoke the anti-abuse rule under IRC Sec. 701 to prevent an abusive allocation.

Proposed amendments would expand the "anti-abuse" language in Reg. 1.704-3(a)(1) and (a)(10) to provide that the tax liabilities of partners and certain direct and indirect owners of partners would be taken into account in determining if a partnership's Section 704(c) allocations are "reasonable" or "abusive." Under the proposed changes, the IRS could examine the effect of a partnership's Section 704(c) allocation method on the present value of (a) the tax liabilities of partners and (b) the tax liabilities of certain direct or indirect owners of partners.

If a property contribution and the related Section 704(c) allocations are made with a view to shifting the tax consequences of the property's built-in gain or loss in a manner that substantially reduces the aggregate present value of such tax liabilities, the IRS can claim the allocations are "unreasonable" because they cause tax results that are inconsistent with the intent of Subchapter K (the partnership provisions of the Tax Code). The IRS can then challenge the Section 704(c) allocation method or even attempt to recast the property contribution transaction. For instance, the IRS could claim that a purported property contribution in connection with a purported partnership formation should simply be ignored with the property being treated as if there was no change in its ownership. The proposed amendments to the Section 704(c) anti-abuse rule would be effective for partnership tax years beginning after the date the amendments are adopted as final regulations.

Making Allocations Using the Traditional Method

The traditional method is described in Reg. 1.704-3(b). The traditional method requires the partnership to allocate any gain or loss upon the disposition of contributed property in a manner that ensures the contributing partner is allocated any precontribution gain or loss. These rules also provide that any cost recovery deductions (depreciation, depletion, or amortization) with respect to contributed property must be allocated in the manner that most rapidly reduces the built-in gain or loss associated with the contributed property. This is usually accomplished by allocating book depreciation based on the economic agreement of the partners (book depreciation in this case is computed based on the FMV of the property), and then allocating tax depreciation to the noncontributing partners up to the amount of book depreciation allocated to those partners. Any remaining tax deductions are then allocated to the contributing partner or shared among the partners. (See Example 3-5 for an example of how this method is applied.) The ceiling rule, discussed previously, applies to Section 704(c) allocations (except for allocations made under the remedial allocation method).

Example 3-5: Using the traditional method.

Stuart and Mary form the Dancing Can Partnership (DC) to manufacture novelty items. Stuart contributes $100,000 cash, and Mary contributes equipment with a $40,000 adjusted tax basis and a $100,000 FMV. They each will receive 50% of all partnership items. The property is depreciated over 10 years using the straight-line method, and has a remaining useful life of five years. They project annual gross sales of $10,000 and expenses other than depreciation of $10,000. Therefore, their net loss will equal the equipment's depreciation expense each year.

The partnership agreement provides for maintenance of capital accounts and allocation of income and loss according to the safe harbor rules. Although the partners are not required to restore deficits in their capital

accounts, the partnership does have a qualified income offset provision. Following is an analysis of Stuart and Mary's options under each of the methods described in the regulations.

Under the traditional method, the allocation of depreciation expense for the first two years of DC's operations would be as follows:

	Stuart		Mary		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Year One contribution	$ 100,000	$ 100,000	$ 100,000	$ 40,000	$ 200,000	$ 140,000
Depreciation	(10,000)	(8,000)	(10,000)	—	(20,000)	(8,000)
Capital account at end of Year One	90,000	92,000	90,000	40,000	180,000	132,000
Year Two depreciation	(10,000)	(8,000)	(10,000)	—	(20,000)	(8,000)
Capital account at end of Year Two	$ 80,000	$ 84,000	$ 80,000	$ 40,000	$ 160,000	$ 124,000

If DC sells the property at the beginning of its third year for $60,000, the partnership recognizes no book gain because the property is sold for its adjusted book basis, but recognizes a tax gain of $36,000 ($60,000 sales price − $24,000 adjusted tax basis). The gain on sale is first allocated to reduce Mary's remaining book/tax difference to zero, with any remaining gain being allocated equally between the partners. Because of the ceiling rule, there is not enough gain to reduce Mary's book/tax difference to zero. The allocation of sales proceeds between the partners would be as follows:

	Stuart		Mary		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Capital account at end of Year Two	$ 80,000	$ 84,000	$ 80,000	$ 40,000	$ 160,000	$ 124,000
Allocation of book gain	—	—	—	—	—	—
Special allocation of tax gain	—	—	—	36,000	—	36,000
Capital account after sale	$ 80,000	$ 84,000	$ 80,000	$ 76,000	$ 160,000	$ 160,000

Were the partnership to liquidate after the equipment sale at the beginning of Year Three, the $160,000 cash would be distributed $80,000 each to Stuart and Mary, leaving Stuart with a positive tax basis capital account of $4,000 and Mary with a negative tax basis capital account of ($4,000). As a result, Stuart would recognize a $4,000 capital loss and Mary would recognize a $4,000 capital gain.

Making Allocations Using the Traditional Method with Curative Allocations

An alternative to the traditional method is the traditional method with curative allocations. This allocation method allows partners to overcome the distortions caused by the application of the ceiling rule by making curative allocations of other partnership items of income or expense. Curative allocations are tax allocations only and do not result in any related economic allocations. A curative allocation is reasonable only to the extent it does not exceed the amount necessary to offset the effect of the ceiling rule for the current tax year, or, in the case of a curative allocation upon disposition of the property, for prior tax years. Additionally, a curative allocation is reasonable only if the items allocated have the same tax effect on the partners as the items affected by the ceiling rule. In addition, only income and expenses actually incurred by the partnership can be used to make curative allocations. See Example 3-6 for an example of how curative allocations are made.

Example 3-6: Using the traditional method with curative allocations.

Assume the same facts as in Example 3-5. The traditional method with curative allocations is designed to prevent the distortions in partnership allocations caused by the operation of the ceiling rule. In this case, the partnership could make curative allocations of income from gross sales to Mary or allocations of other expenses to Stuart. Assuming the partners agree to make curative allocations of income to Mary, the partners' capital accounts from formation through sale of the equipment would be as follows:

	Stuart		Mary		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Year One contribution	$ 100,000	$ 100,000	$ 100,000	$ 40,000	$ 200,000	$ 140,000
Depreciation	(10,000)	(8,000)	(10,000)	—	(20,000)	(8,000)
Other expenses	(5,000)	(5,000)	(5,000)	(5,000)	(10,000)	(10,000)
Gross income	5,000	3,000	5,000	7,000	10,000	10,000
Capital account at end of Year One	90,000	90,000	90,000	42,000	180,000	132,000
Year Two depreciation	(10,000)	(8,000)	(10,000)	—	(20,000)	(8,000)
Other expenses	(5,000)	(5,000)	(5,000)	(5,000)	(10,000)	(10,000)
Gross income	5,000	3,000	5,000	7,000	10,000	10,000
Capital account at end of Year Two	80,000	80,000	80,000	44,000	160,000	124,000
Allocation of book gain	—	—	—	—	—	—
Special allocation of tax gain	—	—	—	36,000	—	36,000
Capital account after sale	$ 80,000	$ 80,000	$ 80,000	$ 80,000	$ 160,000	$ 160,000

Since Stuart (the noncontributing partner) is allocated $10,000 of book depreciation, but only $8,000 of tax depreciation, a curative allocation of $2,000 must be made. In this case, the allocation is $2,000 of gross income to Mary. (It could also have been a curative allocation of $2,000 of partnership expenses to Stuart.) Therefore, for tax purposes, Stuart is only allocated $3,000 of partnership gross income (rather than his $5,000 share), and Mary is allocated $7,000. Note that the curative allocations prevent the distortion of the partners' capital accounts caused by application of the ceiling rule.

Making Allocations Using the Remedial Allocation Method

Under the remedial allocation method, the partnership can, in certain situations, make tax allocations of phantom income or gain created by the partnership to noncontributing partners, with offsetting allocations of loss or deduction created by the partnership to the contributing partner. Remedial allocations are allowed only when there is a book allocation to a noncontributing partner that is different from the tax allocation to that partner. Remedial allocations are tax allocations only and do not affect book capital accounts. Generally speaking, the remedial allocation method allows the partnership to disregard the ceiling rule when a book allocation to a noncontributing partner is different from the corresponding tax allocation. The partnership does not have to actually realize the income, loss, or deduction used to make the remedial allocation.

As with other types of Section 704(c) allocations, a remedial allocation is reasonable only to the extent it equals the amount necessary to offset the ceiling rule for the current tax year, and only if the income or loss allocated has the same effect on each partner's tax liability as the item limited by the ceiling rule (for example, if the item limited by the ceiling rule is a capital loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be a capital gain from the sale of that property). Any partner level tax attributes are determined at the partner level. For example, if the item limited by the ceiling rule is depreciation on a rental property, the remedial allocation to the noncontributing partner must be depreciation from property used in a rental activity, and the offsetting remedial allocation to the contributing partner is ordinary income from that rental activity. Each partner then applies the passive activity loss limitation rules to the allocation as appropriate.

Reg. 1.704-3(d)(3) provides that remedial allocations must have the same effect on each partner's tax liability as the tax item limited by the ceiling rule. This would appear to require an allocation of ordinary income to offset an allocation of cost recovery deductions. However, the regulation goes on to state that if the item limited by the ceiling rule is depreciation, the offsetting remedial allocation must be of the same type of income that the contributed property produces. This statement appears to add some ambiguity to the general rule. What if the cost recovery deductions relate to a Section 1231 asset that generates no income until sold? Best practices indicate that a remedial allocation made to the contributing partner to offset a remedial allocation of depreciation must be ordinary income.

Example 3-7: Using the remedial allocation method.

Assume the same facts as in Example 3-5. Under the remedial allocation method, allocations to Stuart and Mary during Years One and Two would be:

	Stuart		Mary		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Year One						
Contribution	$ 100,000	$ 100,000	$ 100,000	$ 40,000	$ 200,000	$ 140,000
Depreciation on substitute basis property	(4,000)	(4,000)	(4,000)	(4,000)	(8,000)	(8,000)
Depreciation on *new* property	(3,000)	—	(3,000)	—	(6,000)	—
Remedial allocation	—	(3,000)	—	3,000	—	—
Capital account at end of Year One	93,000	93,000	93,000	39,000	186,000	132,000
Year Two						
Depreciation on substitute basis property	(4,000)	(4,000)	(4,000)	(4,000)	(8,000)	(8,000)
Depreciation on *new* property	(3,000)	—	(3,000)	—	(6,000)	—
Remedial allocation	—	(3,000)	—	3,000	—	—
Capital account end of Year Two	$ 86,000	$ 86,000	$ 86,000	$ 38,000	$ 172,000	$ 124,000

If the partnership sold the property for $60,000 at the end of Year Two, a ($12,000) book loss would be recognized ($60,000 sales proceeds − $72,000 adjusted book basis). The partnership would recognize a $36,000 tax gain ($60,000 sales proceeds − $24,000 adjusted tax basis). Allocation of the gain (loss) on sale would be:

	Stuart		Mary		Partnership	
	Book	Tax	Book	Tax	Book	Tax
Capital account at end of Year Two	$ 86,000	$ 86,000	$ 86,000	$ 38,000	$ 172,000	$ 124,000
Allocation of gain (loss)	(6,000)	—	(6,000)	36,000	(12,000)	36,000
	80,000	86,000	80,000	74,000	160,000	160,000
Remedial allocation	—	(6,000)	—	6,000	—	—
Capital account after sale	$ 80,000	$ 80,000	$ 80,000	$ 80,000	$ 160,000	$ 160,000

The $3,000 remedial allocation to Stuart in Years One and Two is of depreciation expense. The offsetting remedial allocation to Mary in Years One and Two is of ordinary income. The ($6,000) remedial allocation to Stuart is Section 1231 loss on the sale of the contributed property, with the offsetting allocation to Mary of a $6,000 Section 1231 gain on the sale of the contributed property.

Comparing the Results of the Three Prescribed Methods

After analyzing the possible effects of allocating deductions relating to Mary's book/tax difference under the traditional method, the traditional method with curative allocations, and the remedial allocation method, Stuart and Mary agree to use the traditional method with curative allocations. They do not want to use the traditional method because of the distortion caused by applying the ceiling rule. Either the remedial allocation method or the traditional method with curative allocations would remedy the distortion problem. Stuart wants to use the traditional method with curative allocations because it results in the most current tax deductions being allocated to him.

Calculating Depreciation under the Remedial Allocation Method. The calculation of book cost recovery deductions under the remedial allocation method is different from the calculation of such amounts under the other two permissible methods. The calculation method used under the remedial allocation method is the same as that used under the deferred sale method of the original proposed regulations. These rules require the partnership to depreciate the portion of the book basis of contributed property equal to its tax basis on the date of contribution

over the remaining life and using the same method used by the contributing partner. The remainder of the partnership's book basis is recovered using any recovery period and method allowed on the contribution date for newly purchased property.

Amortizing Section 197 Intangibles under the Remedial Allocation Method. If a Section 197 intangible that is contributed to a partnership was amortizable to the contributing partner, the partnership may allocate amortization from that asset to its partners under any of the permissible methods. If contributed Section 197 intangibles were not amortizable in the hands of the contributing partner, the intangibles also cannot be amortized by the partnership. However, if the partnership uses the remedial allocation method for making Section 704(c) allocations, the partnership can make remedial allocations of amortization deductions with respect to the contributed Section 197 intangible.

The ability to allocate Section 197 amortization under this rule is subject to the anti-churning rules. Accordingly, remedial allocations of amortization expense cannot be made to partners who are related to the contributing partner. These rules do not apply to property acquired before January 26, 2000 unless a valid retroactive election is made under Temp. Reg. 1.197-1T. These rules were clarified in Rev. Rul. 2004-49, which provides that if a partnership revalues an amortizable Section 197 intangible, it can make reverse Section 704(c) allocations of amortization deductions with respect to the built-in gain or loss from the revaluation (i.e., the increase or decrease, respectively, in the book value of the intangible as a result of the revaluation) to all of its partners under any permissible method.

If the revalued Section 197 intangible is not amortizable in the hands of the partnership, then Reg. 1.197-2(g)(4)(ii) and 1.197-2(h)(12)(vii) generally prevent the partnership from allocating amortization with respect to the intangible but do not prevent the partnership from making remedial allocations of amortization with respect to the intangible. However, remedial allocations of amortization with respect to built-in gain or loss from the revaluation of a Section 197(f)(9) intangible are not allowed to the extent that such allocations are, in substance, the equivalent of a remedial allocation of amortization to a partner that is related to the contributing partner (with respect to the revaluation). Also, under Reg. 1.197-2(h)(12)(vii)(B), remedial allocations of amortization with respect to the built-in gain or loss from the revaluation of a Section 197(f)(9) intangible are not allowed if, as part of a series of related transactions that includes the revaluation, the contributing partners (with respect to the revaluation) or related persons (other than the partnership) become (or remain) direct users of the intangible.

Choosing an Allocation Method That Is Reasonable

A partnership can use different allocation methods with respect to different items of Section 704(c) property. However, the allocation method must be consistently applied by both the partnership and the partners from year to year and must be reasonable. Reg. 1.704-3(a)(2) provides that it may be unreasonable to use one method for appreciated property and another method for depreciated property. Similarly, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner in a high tax bracket, while using curative allocations for built-in gain property contributed by a partner in a low tax bracket. The partnership agreement should discuss which method will be used or who will be responsible for determining the method to be used.

Using the Undivided Interests Method. Prior to the amendment in 1984, the undivided interests method was a specifically stated method under IRC Sec. 704(c). Under this method, allocations of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership were determined as though the undivided interests had not been contributed to the partnership. The undivided interest method is not a specifically identified method in the final regulations because it has limited application. Nevertheless, its use in appropriate situations may be reasonable.

Using the Oil and Gas Method. The application of an allocation method used in the oil and gas industry in appropriate situations may also be reasonable. Under this method, each partner is, in essence, allocated all of the depreciation or depletion from each item of property the partner contributes to the partnership (or from property purchased with cash contributed by the partner). Upon disposition of the contributed property, remaining built-in gain or loss is allocated to the contributing partner, and any additional gain or loss is allocated according to the partnership agreement. Although this method is common in the oil and gas industry, it does not appear to be a generally applicable method and therefore, the IRS has opted not to include it as a specifically identified method in the regulations. However, the use of this method in appropriate situations may be reasonable.

Planning Opportunities for Allocating Built-in Gains

Why Is Choice of a Method Important? The most advantageous method to the contributing partner is the traditional method because no additional income is allocated to him to offset the ceiling rule effects. This method is least beneficial to the noncontributing partner because a smaller amount of depreciation is allocated to him for tax purposes, due to the ceiling rule limitation.

When comparing the remaining methods, the remedial allocation method is more beneficial to the contributing partner than the traditional method with curative allocations when the property has built-in gains. Even though both methods increase the contributing partner's taxable income by creating an offset for the ceiling rule, the remedial allocation method spreads the effects of these allocations over the *new* life of the property's built-in gain as opposed to the remaining life of the contributed property itself in the manner done in the traditional method with curative allocations.

The traditional method with curative allocations will prove to be the most beneficial method to the noncontributing partner because he will receive his entire share of tax depreciation over the contributed property's remaining life. The remedial allocation method basically will do the same thing, but the recovery period will be extended to include the new life assigned to the built-in gain portion of the property.

Choosing a method is an important decision. If the partnership has nonrecourse debt and is using the remedial allocation method, when allocating a tier of debt based on Section 704(c) gain, is the debt allocated based on the hypothetical allocation (including remedial amount) of the gain on sale? If so, the choice of method can affect the amount of basis allocated to each partner.

If a partnership using the traditional method (or any other reasonable method) to allocate built-in gain or loss disposes of Section 704(c) property in a nonrecognition transaction (for example, a like-kind exchange), any substituted basis property received is treated as Section 704(c) property. The property received is deemed to have the same amount of built-in gain or loss as the Section 704(c) property transferred by the partnership. If gain or loss is recognized on the transaction, appropriate adjustments must be made. Additionally, the allocation method chosen for the substituted basis property must be consistent with that used for the original property.

Example 3-8: Planning opportunities for allocating built-in gains.

Jean and Ben are forming the JB Partnership. Jean will contribute $1,000 cash and hold a 10% interest in the partnership. Ben plans on contributing property with a $600 basis and a $9,000 FMV for a 90% interest. They are aware of the Section 704(c) rules regarding the allocation of the built-in gain in Ben's contributed property, and they each plan to consult their own tax practitioner to determine the method most beneficial to them. They are both in the top tax bracket when filing their individual returns.

It appears that Jean and Ben will be at odds over the method to use in allocating the built-in gain from Ben's contributed property. The tax practitioners should calculate the effects of each of the methods and make the results perfectly clear to both partners. If they do not agree on the method to allocate the built-in gain, perhaps concessions can be made in some other area of the partnership agreement to offset the disadvantage suffered by the objecting partner.

Using the Section 704(c) Rules for Small Disparities

A partnership does not have to apply the Section 704(c) rules to a partner's contributions in a single year if both of the following criteria are met:

a. The difference between the FMV and basis of all the contributed properties (in the aggregate) is 15% or less of the properties' basis.

b. The total disparity between the FMV and basis for all properties contributed by the partner during the year does not exceed $20,000.

In such a situation the partnership may:

a. Use a reasonable Section 704(c) method as if the exception did not apply;

b. Disregard the application of IRC Sec. 704(c) to the property altogether; or

c. Defer the application of IRC Sec. 704(c) until the partnership disposes of the property.

Making Allocations for Tiered Partnerships

When an upper-tier partnership contributes Section 704(c) property to a lower-tier partnership, the upper-tier partnership must allocate its distributive share of lower-tier partnership income and expense among upper-tier partners in a manner that takes into account the contributing partner's remaining built-in gain or loss.

Making Allocations That Involve Contributed Section 263A Property

The Section 704(c) regulations do not provide any guidance for contributions to the partnership of items that are subject to IRC Sec. 263A. IRC Sec. 263A requires the capitalization of depreciation, depletion, and amortization for assets that are directly or indirectly utilized for the production, storage, or administration of inventory, self-created assets, and real property produced for sale. There is no suggestion in the regulations that IRC Sec. 704 would not apply to Section 263A property. There is no firm guidance as to how the book/tax differences for these types of items should be handled. One suggestion is that the difference will remain in the item for which the cost recovery is capitalized. The difference will be recognized as Section 704(c) gain or loss when the asset is disposed in a taxable transaction. Another suggestion is that the Section 704(c) gain or loss is recognized when the depreciation, depletion, or amortization is capitalized into inventory, a self-created asset, or real property.

Applying IRC Sec. 704(c) to Technical Terminations

A partnership is considered to terminate for tax purposes if 50% or more of the total interests in partnership capital and profits are sold or exchanged within a 12-month period. This is commonly referred to as a *technical termination*. Under the technical termination rules, the *old* terminating partnership is deemed to contribute all its assets and liabilities tax-free under IRC Sec. 721 to a *new* partnership in exchange for 100% ownership of the *new* partnership. As a result, the *new* partnership's basis in its assets are identical to the basis of the assets in the *old* partnership.

This makes it clear that the Section 704(c) rules apply to the continuing partners in the *new* partnership as if nothing had happened. The partners who acquire interests (thereby causing the technical termination) step-into-the-shoes of the transferor partners unless a Section 754 election is in effect.

Reg. 1.704-4(c)(3) provides that there is no Section 704(c)(1)(B) gain or loss recognized when a technical termination occurs. This is because there is no deemed distribution of the *old* partnership's assets. However, the continuing partners' precontribution gains or losses carry over to their interests in the *new* partnership when the Section 704(c)(1)(B) rules apply to continuing partners as if nothing happened.

Creating Section 704(c) Gain or Loss in an Assets-over Partnership Merger

In and of itself, an assets-over merger will not trigger gain under the Section 737 rules because assets are not distributed to partners in such mergers. However, Prop. Reg. 1.737-2(b)(1) states that contributions of appreciated partnership property to the transferee partnership in an assets-over merger can create new Section 704(c) gain for certain partners of the merging partnerships. To the extent that new Section 704(c) gain is created, affected partners are potentially exposed to additional gain recognition under the Section 737 rules for distributions that occur up to seven years after the merger. Under an exception, the Section 737 rules will not apply to new Section 704(c) gain created by an assets-over merger when the ownership of the transferor and transferee partnerships are identical or when the ownership is only different by *de minimis* amounts.

On another favorable note, Prop. Reg. 1.737-2(b)(1) provides that an assets-over merger does not restart the seven-year period under the Section 737 rules for the original Section 704(c) gain (i.e., built-in gain that existed when property was originally contributed to a partnership that is later involved in the assets-over merger).

The proposed regulations summarized in the preceding discussion apply to partnership distributions of property that occur after January 19, 2005 if such property was contributed in an assets-over merger after May 3, 2004.

Applying IRC Sec. 704(c) to Depreciation Recapture among Partners

IRC Sec. 1245 requires taxpayers to recharacterize some or all of the gain on disposition of certain types of business properties into ordinary income. The amount recharacterized is the lesser of (a) the gain realized on the disposition or (b) the total deductions allowed or allowable for depreciation or amortization from the property.

Regulations under IRC Sec. 1245 provide that a partner's share of recapture gain is equal to the lesser of (a) the partner's share of total gain arising from the disposition of the property or (b) the partner's share of depreciation or amortization from the property. This ensures that a partner recognizes recapture income on the disposition of property equal to the depreciation or amortization deductions previously taken by the partner on the property. If recapture gain remains unallocated under the general rule, the remaining unallocated gain is allocated among the partners whose shares of total gain on the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Recapture gain may be unallocated under the general rule if, for example, the total gain allocated to a partner on the sale of the property is less than the amount of depreciation previously allocated to that partner.

While the regulations were issued under IRC Sec. 1245, the same rules apply to allocations of Section 1250 depreciation recapture income. [Reg. 1.1250-1(f) mandates following Section 1245 principles in allocating Section 1250 recapture among partners.]

If a partnership interest is transferred, the depreciation recapture potential is also transferred to the new partner, unless it is reduced or eliminated by stepping up the transferee partner's share of the basis of partnership property.

When a partner contributes built-in gain property covered by the Section 704(c) rules, the contributing partner's share of depreciation deductions includes the allowed or allowable deductions before the contribution. Therefore, the allocation of recapture income follows the gain allocation under the Section 704(c) rules. As a result, the Section 704(c) method chosen to allocate built-in gain on the contributed property affects how much depreciation recapture each partner is allocated.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

28. Leo and Lola form a partnership. Leo contributes $2,000 cash, and Lola contributes a nondepreciable asset with $2,000 FMV and a $1,200 tax basis. They have equal economic interest in partnership profits and losses. Under the safe harbor book capital account rules, they each have opening book capital accounts of $2,000. The asset decreases in value to $1,800, and the partnership sells it. This gives the partnership a $200 economic loss, but a $600 tax gain. Calculate each partner's ending tax basis.

    a. Leo: $100; Lola: $100.

    b. Leo: $1,900; Lola: $1,900.

    c. Leo: $2,000; Lola: $1,800.

    d. Leo: $2,000; Lola: $2,000.

29. The Parallel Partnership is making allocations under IRC Sec. 704(c). Which of the following types of property can the partnership aggregate?

    a. Property included in the same general asset account of the partnership and the contributing partner.

    b. Property that has a basis equal to $100 or less.

    c. Inventory, if the partnership uses the specific identification method of accounting.

    d. No types of property can be aggregated when making Section 704(c) elections.

30. The Uh Oh Partnership makes tax allocations using an allocation method that triggers the anti-abuse rule. What action is the IRS not allowed to take once this rule has been invoked?

    a. Requiring the partnership to use the remedial allocation method.

    b. Making curative allocations to reduce the tax effect of the abusive method.

    c. Invoking the anti-abuse rule under IRC Sec. 701.

31. The Icicle Partnership sells property; however, due to the ceiling rule, the partnership cannot allocate enough gain to Joe, the contributing partner, to eliminate his book/tax difference. Therefore, the partners agree to allocate income from gross sales to Joe to eliminate that difference. What allocation method was used?

    a. Traditional method.

    b. Traditional method with curative allocations.

    c. Remedial allocation method.

32. A Section 197 intangible is contributed by Tad to the Branch Partnership. The intangible is not amortizable by either Tad or the partnership. Use of which method for Section 704(c) allocations will allow the partnership to make allocations of amortization deductions with respect to the intangible?

    a. Traditional method.

    b. Traditional method with curative allocations.

    c. Remedial allocation method.

    d. The partnership can use any of the allocation methods to achieve this result.

33. What term matches the following definition?

    An allocation method under which each partner is allocated all of the depletion or depreciation from each item of property that he or she contributes to the partnership.

    a. Traditional method.

    b. Remedial allocation method.

    c. Undivided interests method.

    d. Oil and gas method.

34. Which of the following partnerships qualifies for the exception for small disparities?

    a. In 2010, the difference between the FMV of Partnership One and the basis of all its contributed properties (aggregated) is 17% of the properties' basis.

    b. In 2010, the total disparity between the FMV and the basis for all properties contributed by a partner during the year to Partnership Two is $21,333.

    c. In 2009, the difference between the FMV of Partnership Three and the basis of all its contributed properties (aggregated) is 4.7% of the properties' basis, and in 2010, the total disparity between its FMV and the basis for all properties contributed to it by a partner during the year is $10,000.

    d. In 2010, the difference between the FMV of Partnership Four and the basis of all its contributed properties (aggregated) is 10% of the properties' basis, and the total disparity between its FMV and the basis for all properties contributed to it by a partner during the year is $15,000.

35. The Legion Partnership disposes of business property that is affected by IRC Sec. 1245. Ken, a partner, qualifies for a share of recapture gain. Ken had contributed the property that had built-in gain to the partnership, and the traditional allocation method was elected. Will Ken's allocation of recapture income be affected?

    a. Yes.

    b. No.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

28. Leo and Lola form a partnership. Leo contributes $2,000 cash, and Lola contributes a nondepreciable asset with $2,000 FMV and a $1,200 tax basis. They have equal economic interest in partnership profits and losses. Under the safe harbor book capital account rules, they each have opening book capital accounts of $2,000. The asset decreases in value to $1,800, and the partnership sells it. This gives the partnership a $200 economic loss, but a $600 tax gain. Calculate each partner's ending tax basis. **(Page 162)**

    a. Leo: $100; Lola: $100. [This answer is incorrect. This is the amount of economic loss that will be attributed to each partner under the safe harbor rules. This is not their tax basis amount.]

    b. Leo: $1,900; Lola: $1,900. [This answer is incorrect. Under the safe harbor rules, the economic loss is allocated $100 to each partner, thereby reducing their book capital accounts to $1,900 each. It appears that the proper way to treat the tax allocations is to allocate Lola a $700 tax gain and Leo a $100 tax loss. This allocation would give each partner a $1,900 tax basis, matching the ending book capital accounts. However, due to the ceiling rule, this tax allocation is not valid.]

    c. Leo: $2,000; Lola: $1,800. [This answer is correct. The ceiling rule limits the total tax allocation of gain in this scenario to $600, so all of it would be allocated to Lola. As a result, Lola's ending tax basis is $1,800, and Leo's ending basis is $2,000. If the partnership liquidates, Lola will recognize a $100 gain, and Leo will recognize a $100 loss because the liquidating distributions would be based on their ending book capital accounts of $1,900 each.]

    d. Leo: $2,000; Lola: $2,000. [This answer is incorrect. Under the safe harbor rules and the ceiling rule, changes will be made to the opening book capital accounts.]

29. The Parallel Partnership is making allocations under IRC Sec. 704(c). Which of the following types of property can the partnership aggregate? **(Page 163)**

    a. Property included in the same general asset account of the partnership and the contributing partner. [This answer is correct. Under the regulations, the type of property described in this answer choice can be aggregated for Section 704(c) allocations, as long as it is not real property.]

    b. Property that has a basis equal to $100 or less. [This answer is incorrect. Per the regulations, property, other than real property, with a basis equal to zero can be aggregated.]

    c. Inventory, if the partnership uses the specific identification method of accounting. [This answer is incorrect. According to the regulations, inventory, other than securities or similar investments, can be aggregated if the partnership does not use the specific identification method of accounting.]

    d. No types of property can be aggregated when making Section 704(c) elections. [This answer is incorrect. Property generally cannot be aggregated for the purposes of making allocations under IRC Sec. 704(c). However, under the regulations, three specific types of property are allowed to be aggregated.]

30. The Uh Oh Partnership makes tax allocations using an allocation method that triggers the anti-abuse rule. What action is the IRS not allowed to take once this rule has been invoked? **(Page 164)**

    a. Requiring the partnership to use the remedial allocation method. [This answer is correct. Reg. 1.704-3(d)(5)(ii) specifically provides that the IRS cannot require the partnership to use the remedial allocation method, which permits the allocation of notional tax items.]

    b. Making curative allocations to reduce the tax effect of the abusive method. [This answer is incorrect. Under the regulations, the IRS is allowed to make curative allocations in this type of circumstance. An allocation method will not be considered reasonable if the contribution and the allocations with respect to the

contributed property are made with the intent to shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.]

c. Invoking the anti-abuse rule under IRC Sec. 701. [This answer is incorrect. If the anti-abuse rule is triggered, the IRS may choose to invoke the anti-abuse rule under IRC Sec. 701 to prevent an abusive allocation.]

31. The Icicle Partnership sells property; however, due to the ceiling rule, the partnership cannot allocate enough gain to Joe, the contributing partner, to eliminate his book/tax difference. Therefore, the partners agree to allocate income from gross sales to Joe to eliminate that difference. What allocation method was used? **(Page 165)**

a. Traditional method. [This answer is incorrect. The traditional method is described in Reg. 1.704-3(b). Under the traditional method, if the ceiling rule did not allow the allocation, the book/tax difference could not be eliminated.]

b. Traditional method with curative allocations. [This answer is correct. Under the regulations, the use of curative allocations can mitigate ceiling rule distortions, as with the scenario above.]

c. Remedial allocation method. [This answer is incorrect. Under the regulations, remedial allocations are allowed only when there is a book allocation to a noncontributing partner that is different from the tax allocation to that partner.]

32. A Section 197 intangible is contributed by Tad to the Branch Partnership. The intangible is not amortizable by either Tad or the partnership. Use of which method for Section 704(c) allocations will allow the partnership to make allocations of amortization deductions with respect to the intangible? **(Page 168)**

a. Traditional method. [This answer is incorrect. According to the regulations, the traditional method can not be used in this situation.]

b. Traditional method with curative allocations. [This answer is incorrect. Per the guidance found in the IRS regulations, the traditional method with curative allocations would not allow the partnership to achieve the desired results in the scenario described above.]

c. Remedial allocation method. [This answer is correct. If the partnership uses the remedial allocation method for making Section 704(c) allocations, the partnership can make remedial allocations of amortization deductions with respect to the contributed Section 197 intangible, per the regulations.]

d. The partnership can use any of the allocation methods to achieve this result. [This answer is incorrect. If the Section 197 intangible were amortizable to Tad, the partnership could allocate amortization from that asset to its partners under any of the permissible methods under the regulations. However, that is not the case in this scenario.]

33. What term matches the following definition? **(Page 168)**

> An allocation method under which each partner is allocated all of the depletion or depreciation from each item of property that he or she contributes to the partnership.

a. Traditional method. [This answer is incorrect. Under the regulations, this is not the definition of the traditional method, which requires the partnership to allocate gain or loss upon the disposition of contributed property in a way that ensures the contributing partner is allocated only precontribution gain or loss.]

b. Remedial allocation method. [This answer is incorrect. The definition of the remedial allocation method found in the regulations does not match the definition provided in this question. Generally speaking, the remedial allocation method allows the partnership to disregard the ceiling rule when a book allocation to a noncontributing partner is different from the corresponding tax allocation.]

c. Undivided interests method. [This answer is incorrect. Under this method, as described in a prior version of the regulations, allocations of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership were determined as though the undivided interests had not been contributed to the partnership.]

d. Oil and gas method. [This answer is correct. This is the definition of the oil and gas method. Although, this allocation method is used in the oil and gas industry, it does not appear to be a generally applicable method. However, the use of this method in appropriate situations may be reasonable.]

34. Which of the following partnerships qualifies for the exception for small disparities? **(Page 169)**

a. In 2010, the difference between the FMV of Partnership One and the basis of all its contributed properties (aggregated) is 17% of the properties' basis. [This answer is incorrect. According to the regulations for the small disparities exception, the difference between the FMV and the basis of the contributed properties is too high of a percentage.]

b. In 2010, the total disparity between the FMV and the basis for all properties contributed by a partner during the year to Partnership Two is $21,333. [This answer is incorrect. Per the regulations for the small disparities exception, the amount of the disparity between the FMV and the basis for all the properties contributed by the one partner is too high.]

c. In 2009, the difference between the FMV of Partnership Three and the basis of all its contributed properties (aggregated) is 4.7% of the properties' basis, and in 2010, the total disparity between its FMV and the basis for all properties contributed to it by a partner during the year is $10,000. [This answer is incorrect. Under the regulations, the partnership has to meet all the qualifications for the small disparities exception in a single year. This answer does not provide all of the required information for a specific year to allow consideration of this exception.]

d. In 2010, the difference between the FMV of Partnership Four and the basis of all its contributed properties (aggregated) is 10% of the properties' basis, and the total disparity between its FMV and the basis for all properties contributed to it by a partner during the year is $15,000. [This answer is correct. According to the regulations, the amounts for Partnership Four come in below the maximum levels allowed for the small disparities exception (15% and $20,000). In this situation, the partnership can (1) use a reasonable Section 704(c) exception as if the exception did not apply, (2) disregard the application of IRC Sec. 704(c) to the property altogether, or (3) defer the application of IRC Sec. 704(c) until the partnership disposes of the property.]

35. The Legion Partnership disposes of business property that is affected by IRC Sec. 1245. Ken, a partner, qualifies for a share of recapture gain. Ken had contributed the property that had built-in gain to the partnership, and the traditional allocation method was elected. Will Ken's allocation of recapture income be affected? **(Page 171)**

a. Yes. [This answer is correct. The allocation of recapture income follows the gain allocation under the Section 704(c) rules. As a result, the Section 704(c) method chosen to allocate built-in gain on the contributed property affects how much depreciation recapture each partner is allocated.]

b. No. [This answer is incorrect. Both the Section 1245 rules and the Section 704(c) rules will apply in this scenario.]

THE ALLOCATION OF LOSSES AND DEDUCTIONS ATTRIBUTABLE TO NONRECOURSE LIABILITIES

Complex rules apply to the allocation of losses and deductions attributable to partnership nonrecourse liabilities. These nonrecourse deduction rules typically are most important in connection with real estate investments, where nonrecourse borrowings are common. The rules for allocating deductions and gain related to nonrecourse debt under IRC Sec. 704(b) are coordinated with the rules for allocating basis from debt under IRC Sec. 752. This ensures that the same partners who are allocated a share of nonrecourse debt for basis purposes are allocated the losses or gain related to that debt. A partnership may be required to allocate its nonrecourse deductions under the final regulations issued December 28, 1991, the temporary regulations issued December 29, 1988, or the rules in former Reg. 1.704-1(b)(4)(iv). See the discussion of effective dates later in this lesson. The 1988 temporary regulations and the final regulations contain substantially the same provisions. The discussion that follows is based on the final regulations with discrepancies between the temporary and final regulations noted.

Understanding General Allocation Principles

An allocation of an item of loss that is attributable to a nonrecourse liability cannot, by definition, have economic effect because, in the event that there is an economic burden related to the allocation, the creditor bears the burden, not the partners. The general rule is that losses related to nonrecourse liabilities—*nonrecourse deductions*—must be allocated in accordance with the partners' interests in the partnership.

Since the concept of partners' interests in the partnership is difficult to apply, the regulations provide a safe harbor for allocating nonrecourse deductions. If, however, the partnership's allocations of nonrecourse deductions do not comply with the safe harbor provisions, the allocations are determined in accordance with the broader partners' interests in the partnership rules.

The regulations governing the allocation of profits and losses attributable to nonrecourse liabilities have three primary goals:

a. To place reasonable controls on the allocation of losses related to nonrecourse deductions, so that there is a rational relationship between the nonrecourse losses allocated to a partner and that partner's economic interest in the partnership.

b. To ensure that the partners who are allocated losses attributable to nonrecourse liabilities, or who receive distributions produced by nonrecourse liabilities, are allocated the corresponding minimum gain.

c. To ensure that nonrecourse loans from partners or persons related to a partner are treated as recourse liabilities.

Recognizing What Is a Nonrecourse Liability

A *nonrecourse liability* is defined by cross-reference to the regulations under IRC Sec. 752 as any partnership liability for which no partner or related person bears any economic risk of loss. Economic risk of loss is defined under the Section 752 regulations for purposes of determining a partner's basis in his partnership interest. Under this definition, if any partner, or any person related to a partner, bears the risk of loss, in any capacity (for example, as the lender, as a guarantor, or under a transaction that is tantamount to a guarantee), the liability is treated as recourse, and the allocation of the related deductions is subject to the rules governing recourse liabilities.

Understanding the Concept of Minimum Gain

The key to the treatment of deductions and distributions related to nonrecourse liabilities is the concept of *minimum gain*. Generally, when property that secures nonrecourse liabilities is disposed of, the nonrecourse liabilities are treated as an amount realized irrespective of the FMV of the property. If the basis of the property is less than the amount of the liability, there is a tax gain on the disposition of the property regardless of its value; in other words, there is an unavoidable amount of minimum gain on such a disposition. Minimum gain is defined as the excess of the nonrecourse liabilities secured by partnership property over the book basis of the collateral property. Minimum

gain is determined by reference to the book basis of property, not tax basis. The tax gain, if any, is allocated in the manner that is most consistent with the book allocations. In most cases the relationship between the tax and economic allocations is obvious (and frequently identical), but that is not always the case.

Minimum gain is generally created in one of two ways, either by a deduction (generally, depreciation) attributable to basis produced by nonrecourse borrowing, or by a nonrecourse borrowing that produces cash (for instance, the distribution of nonrecourse refinancing proceeds). Minimum gain can also be created by refinancing or converting a recourse debt to a nonrecourse debt. A *nonrecourse deduction* is defined as a deduction that produces minimum gain. Such a deduction can either be depreciation, amortization, or a cash expenditure financed by nonrecourse borrowing.

The allocation of nonrecourse deductions to a partner, and the distribution to a partner of cash related to nonrecourse borrowing, reduces the partner's capital account. Under the safe harbor economic effect rules, a partner cannot be allocated a recourse loss that would result in the partner's book capital account becoming negative if that partner does not have a deficit capital account restoration obligation (or the partnership does not have a qualified income offset provision). However, the prohibition against losses creating negative capital accounts does not apply to nonrecourse deductions, because the deductions, by definition, are associated with an identical amount of minimum gain. Under the regulations, minimum gain must be allocated to the partner who was allocated the corresponding nonrecourse deduction (subject to certain exceptions discussed below). This allocation of minimum gain based on the amount of previously allocated nonrecourse deductions is known as a *minimum gain chargeback*. Similarly, to the extent that a partner receives a distribution that is attributable to nonrecourse liabilities (which can also result in that partner's capital account becoming negative), the partner must receive a chargeback of the corresponding minimum gain.

There are four limited situations in which a decrease in minimum gain can occur without application of the minimum gain chargeback rule:

a. The decrease results from the conversion of nonrecourse debt to recourse debt (due to refinancing, a guarantee, or other changes in the debt instrument) and the partner bears the economic risk of loss with regard to the refinanced, newly guaranteed, or otherwise changed debt.

b. The decrease results from a contribution by the partner that is used to repay the nonrecourse liability or increase the basis of the property subject to the nonrecourse liability.

c. The decrease results solely from a revaluation of the book basis of partnership assets and partner capital accounts.

d. The Commissioner waives the requirement where it would result in a distortion of the economic agreement of the partners (for example, if the partner has already been allocated other gain, such as charging back the nonrecourse deduction amounts from operating income instead of upon sale of the property).

In these cases, the chargeback of minimum gain is deferred until the occurrence of some subsequent triggering event.

Example 3-9: Determining permissible sharing ratios for allocating nonrecourse deductions.

Judy and Sue each contribute $1,000 to form a partnership. The partnership purchases rental real estate for $10,000 using the $2,000 cash and proceeds of an $8,000 nonrecourse loan from an independent third party. The loan is secured by the property. The property is depreciated straight-line over 10 years. There is a $1,000 net loss each year equal to the partnership's depreciation expense. Judy could use tax deductions, while Sue does not need them. They agree to allocate all losses 90% to Judy and 10% to Sue until the property begins to produce a profit. At that time, 90% of all profits will be allocated to Judy and 10% to Sue until the previously allocated losses are charged back. After that point, profits will be shared 50/50. The partners anticipate that they ultimately will earn profits in excess of their investments. Subject to the requirements for liquidation of the partnership according to book capital accounts and an obligation to restore negative capital accounts, all cash flow will be shared 50/50. The partnership agreement complies with all the requirements of the safe harbor rules and specifically provides for a minimum-gain chargeback provision.

The first $2,000 of depreciation does not produce minimum gain because these deductions are attributable to the cash invested in the property. Allocating $1,800 of these losses to Judy has economic effect because Judy's book capital account is charged with the losses, and the partnership will liquidate according to book capital accounts. As the cash invested in the property is equal to 20% of the total value of the property, it is likely that the losses related to that cash investment would be deemed to be a significant partnership item related to the property securing the nonrecourse liability. Consequently, allocating the nonrecourse deductions in the same proportion (or in a reasonably consistent proportion) as the allocation of these cash losses will likely fall within the safe harbor.

Because the partners reasonably expect to incur profits, and they will share those profits equally if they materialize, allocation of the nonrecourse deductions 50/50 to each partner would probably also be permissible. Since 50/50 and 90/10 are permissible allocations, any allocation ratio between those two would most likely be allowed.

Allocating Nonrecourse Deductions under the Safe Harbor Provisions

Deductions that relate to nonrecourse liabilities by definition do not have economic effect because partnership creditors bear the actual economic burden. Therefore, deductions attributable to nonrecourse liabilities (nonrecourse deductions) must be allocated in accordance with the partners' interests in the partnership. There are two ways this can be accomplished:

a. The deduction can be allocated under the safe harbor nonrecourse deduction allocation provisions.

b. The deduction can be allocated in accordance with the partners' interests in the partnership under Reg. 1.704-1(b)(3).

Allocations of nonrecourse deductions fall within the safe harbor if all of the following requirements are met:

a. Book capital accounts are maintained under the substantial economic effect safe harbor rules and liquidations are in accordance with such capital accounts.

b. Nonrecourse deductions are allocated among the partners in a manner reasonably consistent with allocations of some other significant partnership item having substantial economic effect and related to the property securing the applicable nonrecourse liability.

c. The partnership agreement contains a minimum gain chargeback provision.

d. All other material allocations and capital account adjustments under the partnership agreement are recognized under the regulations (safe harbor or partners' interests in the partnership).

Nonrecourse deductions allocated to a partner reduce the partner's book capital account (even though the deductions do not have economic effect). Correspondingly, allocations of minimum gain are added back to the partner's book capital account. Minimum gain that is attributable to nonrecourse deductions taken by the partnership must be allocated to the partners who received the corresponding nonrecourse deductions. Minimum gain that is attributable to a distribution of proceeds of a nonrecourse liability must be allocated to the partners who received the distribution. (See the discussion later in this lesson.)

The amount of partnership nonrecourse deductions for the year is equal to the excess during the year of the increase in the minimum gain over the distributions of proceeds from nonrecourse liabilities. These nonrecourse deductions are treated as consisting of:

a. First, depreciation or cost recovery deductions from the partnership property securing the nonrecourse liabilities, to the extent the increase in minimum gain is attributable to those properties. (If the depreciation deductions exceed the total minimum gain for the year, a proportionate amount of each deduction is treated as a nonrecourse deduction.)

b. Second, to the extent of any remaining nonrecourse deductions, a prorata portion of all other items of partnership loss and deduction (including losses that are not deductible for tax purposes).

When a partnership has more than one property secured by nonrecourse liabilities, a portion of the nonrecourse deductions is attributable to each property. To determine the amount of gain allocated to each property, the following calculation is used:

$$\text{Total increase in minimum gain for the year} \times \frac{\text{Cost recovery deductions attributable to the property (to the extent of minimum gain for the property)}}{\text{Total cost recovery deductions of the partnership (to the extent of minimum gain)}}$$

If the net increase in partnership minimum gain for the year exceeds the sum of the total nonrecourse deductions and the total distribution of nonrecourse proceeds, the balance is carried over and is deemed to be an increase in minimum gain in the next succeeding tax year. This could easily happen, for example, if the increase in minimum gain relates to funds borrowed on a nonrecourse basis and retained by the partnership.

Understanding the Mechanics of Minimum Gain

Minimum gain is the amount by which nonrecourse liabilities exceed the book basis of the property securing the liability. The partnership's minimum gain is the total minimum gain for all partnership property subject to nonrecourse liabilities. If a property is subject to two or more liabilities of equal security priority, the property's basis is allocated among the liabilities in proportion to their outstanding balances. Otherwise, the property's basis is allocated first to liabilities of superior security priority. Basis is allocated to an inferior liability only when total basis exceeds the principal amount of superior liabilities. Only the portion of the basis allocated to a nonrecourse liability is used in determining minimum gain.

Minimum gain usually arises in one of two ways:

a. The depreciation or amortization of property causes the book basis to fall below the amount of the nonrecourse liability secured by the property.

b. The partnership refinances the property (or obtains a second mortgage), and as a result, the amount of the nonrecourse liability exceeds the book basis of the property securing the nonrecourse liability.

Minimum gain can decrease in a number of ways, including:

a. The principal of the nonrecourse liability is paid down.

b. A previously nonrecourse liability is converted into a recourse liability.

c. The property securing the nonrecourse debt is revalued in a mandatory or optional bookup. (See the discussion earlier in this course.)

Allocating Minimum Gain Chargeback

If there is a net decrease in partnership minimum gain during the tax year, the partners must, under the safe harbor rules, be allocated a minimum gain chargeback. The chargeback is an allocation to each partner of income and gain for such year (and, if necessary, subsequent years) equal to the partner's share of the net decrease in partnership minimum gain.

The minimum gain chargeback for a tax year is considered to consist first of gains from the disposition of property to the extent that the minimum gain decrease is allocable to such disposition. To the extent the amount of the chargeback exceeds the gain from dispositions of property subject to nonrecourse debt, the chargeback is deemed to consist of a proportionate amount of all other items of income and gain. There is no guidance in the regulations for when the gain on the disposition of encumbered property exceeds the minimum gain chargeback.

A partner's share of the net decrease in partnership minimum gain for any year is the net decrease for the year multiplied by the partner's percentage interest in total partnership minimum gain at the end of the immediately

preceding tax year. The partner's share of the total partnership minimum gain at the end of any year is the excess, if any, of the—

a. total nonrecourse deductions allocated to the partner to date, plus the total distributions of proceeds of nonrecourse liabilities to the partner to date, over

b. total minimum gain decrease allocated to the partner to date, plus the total minimum gain decrease from revaluations of partnership property allocated to the partner to date.

When determining the partner's share of minimum gain, the term *partner* includes both the current partner and the partner's predecessors in interest.

Also, a partner's share of partnership minimum gain is increased by an amount equal to his share of any recourse liability that became nonrecourse as a result of a refinancing, lapse of guaranty, or other change.

Allocating Nonrecourse Deductions in Tiered Ownership Arrangements

For tiered partnerships, the parent (upper-tier) partnership's share of the subsidiary (lower-tier) partnership's nonrecourse deductions and distribution proceeds is treated as an increase in minimum gain at the upper-tier partnership. A decrease in minimum gain at the lower-tier partnership is treated as a decrease in minimum gain by the upper-tier partnership.

Recently a Tax Court ruling created a great deal of uncertainty regarding how the partner's interests in the partnership (PIP) rules should apply to tiered ownership arrangements where nonrecourse deductions were being allocated. For this reason, the Ninth Circuit vacated the decision. In *Interhotel Company Ltd. v. Com.*, the Tax Court failed to take into account the minimum gain chargeback relating to prior nonrecourse deductions claimed by partnerships that were subsidiaries of Interhotel Company (a limited partnership) when determining the allocations that would occur upon the deemed liquidation of Interhotel Company. The Tax Court held that because Interhotel Company did not own a controlling interest in the subsidiary partnerships, it could not cause the subsidiaries to liquidate, forcing a minimum gain chargeback. The Tax Court failed to recognize that a deficit capital account resulting from an allocation of nonrecourse deductions does not have an economic effect and should not be considered when determining the interests of the partners in liquidation proceeds (since the deficit will be restored by the minimum gain chargeback resulting from the deemed liquidation).

Handling Minimum Gain and Book/Tax Differences

Minimum gain is determined by reference to the partnership's book capital account value for property, and not by reference to the property's tax basis. For example, if a property is contributed to a partnership at a time when its FMV is $1,000 and its tax basis is $600, and the property secures a nonrecourse liability of $800, the partnership does not have any minimum gain immediately after the contribution because the book capital account value of $1,000 exceeds the related nonrecourse liabilities. This is true notwithstanding that there is $200 in minimum taxable gain under IRC Sec. 1001 immediately after the contribution (the difference between the nonrecourse debt and tax basis).

The allocation of minimum gain where there is a book/tax difference can be complicated and result in surprising allocations. For example, assume that the asset in the preceding paragraph is depreciable straight-line over five years for tax purposes and that the safe-harbor approach is used to determine book depreciation (so that the book depreciation is also straight line over five years). The first year depreciation is $200 for book capital account purposes and $150 for tax purposes. There is no increase in minimum gain, as the book capital account basis and the debt both are $800 at the year-end. All of the book depreciation is considered to be a recourse allocation and is allocated among the partners accordingly. The tax depreciation is allocated to the partners who received the book depreciation allocations, under Section 704(c) principles. Although the tax basis of the property includes the amount of the nonrecourse liability, and each partner's basis in his partnership interest includes his share of the nonrecourse liability, the book allocation is deemed to be a recourse allocation. Therefore, the partners receive tax allocations treated as recourse allocations that they deduct against basis arising from their shares of nonrecourse debt.

The situation is even more complicated where the partnership's assets are revalued for book purposes under the Section 704(b) regulations, and the minimum gain amount is changed because of the revaluation. Although the minimum gain amount is reduced or eliminated by the revaluation, the regulations provide for a deemed corresponding increase in minimum gain for the year of the revaluation.

Distributing the Proceeds of Nonrecourse Liabilities

If a partnership distributes the proceeds from a nonrecourse liability to its partners, the distribution is treated as an increase in partnership minimum gain to the extent that there is a net increase in the partnership minimum gain attributable to the nonrecourse liability.

Any reasonable method can be used to determine (a) if a distribution by the partnership is allocable to the proceeds of a nonrecourse liability, and (b) to which partners a distribution was made. Use of the interest tracing rules under IRC Sec. 163 for allocating debt proceeds among expenditures and identifying the partners receiving such allocations is a reasonable method.

Example 3-10: Distributing the proceeds of nonrecourse liabilities which are treated as a nonrecourse distribution.

Assume that a partnership owns one unencumbered asset, a depreciable piece of property. The property's book and tax basis is $10,000 and it is depreciated on a straight-line basis, with a remaining life of five years. The FMV of the property is $25,000.

In the current year the partnership borrows $15,000 on a nonrecourse basis using the partnership property for security, and distributes the proceeds to the partners. Also in the current year, the partnership has $2,000 in depreciation with respect to the property. At the end of the year the property's basis is reduced to $8,000 and the minimum gain is $7,000 (the nonrecourse liability, $15,000, less the property's basis, $8,000). The net increase in partnership minimum gain for the year is also $7,000.

Under these facts, $7,000 of the distribution is treated as a nonrecourse distribution. The full amount of the distribution is treated as a net increase in minimum gain attributable to the liability for the year, and the depreciation deduction is not a nonrecourse deduction, but is analyzed under the normal capital account rules.

A partnership has the option to treat a distribution of nonrecourse debt proceeds as a distribution that does not create an increase in partnership minimum gain to the extent the distribution does not cause or increase a deficit balance in the distributee partner's capital account that exceeds the amount the partner is otherwise obligated to restore.

Handling Nonrecourse Debt When a Partner Bears the Economic Risk of Loss

If a partner, or any person related to a partner, bears an economic risk of loss with respect to a partnership liability, a deduction related to such liability is not considered to be a nonrecourse deduction. This determination is made notwithstanding that the liability may be a nonrecourse debt to the partnership (a debt that is considered nonrecourse for purposes of Reg. 1.1001-2 or any partnership liability for which the creditor's right to repayment is limited to one or more assets of the partnership). Such liabilities are called *partner nonrecourse debts*, rather than nonrecourse liabilities. Whether or not a partner has an economic risk of loss with respect to any partnership liability is determined under the Section 752 regulations. The Section 752 regulations govern the sharing of partnership liabilities among the partners for determining the partners' bases in their partnership interests.

Any item of partnership deduction that is attributable to a partner nonrecourse debt (a nonrecourse debt for which a partner has an economic risk of loss) is allocated to the partners that bear the associated economic risk of loss. Any minimum gain resulting from such debts is charged back to those same partners.

Identifying Exculpatory Liabilities

An exculpatory liability is a liability that is nonrecourse in that no partner or person related to a partner has any economic risk of loss for the liability, but that is not secured by specific partnership property. Rather, an exculpatory

liability is a general recourse liability to the partnership as an entity. Most otherwise recourse debt of an LLC classified as a partnership is exculpatory since no member has personal liability.

The preamble to the Section 704 regulations provides that exculpatory debts are treated as nonrecourse liabilities. However, the preamble also recognizes that there may be a problem in allocating exculpatory debts under the Section 752 regulations' rules. This problem stems generally from the fact that one of the tiers used to allocate nonrecourse debts is minimum gain—a hypothetical gain calculation based on a sale of property secured by nonrecourse debt. Since exculpatory debt is not secured by specific property, it is not clear how the Section 752 regulations should apply. The preamble states that exculpatory debts should be allocated ". . . in a manner that reasonably reflects the principles of Section 704(b)."

Determining Which Set of Nonrecourse Deduction Allocation Regulations Apply

The final regulations issued December 28, 1991, apply to all partnership tax years beginning on or after December 28, 1991. Partnership tax years beginning after December 29, 1988, but before December 28, 1991, are governed by the temporary regulations in effect during that period. For partnership tax years beginning prior to December 28, 1991, the rules in former Reg. 1.704-1(b)(4)(iv) apply.

If the partnership agreement was entered into during the effective period of any of the sets of regulations and complied with the requirements of the regulations then in effect, the regulations in effect at the time of the agreement continue to apply for all partnership tax years so long as the partnership neither elects to have the current regulations apply nor materially modifies the partnership agreement.

The final regulations expand the grandfather rule for related-party partner nonrecourse debt by making it clear that the grandfather rules apply to all debt incurred prior to January 30, 1989 (or debt incurred after that date pursuant to a binding written contract entered into prior to that date), where a person related to a partner (but not a partner directly) has the economic risk of loss for such debt. Such debt incurred prior to January 30, 1989, is treated as a nonrecourse liability of the partnership and not as a partner nonrecourse liability, so long as the debt is not materially modified on or after January 30, 1989, and the partnership consistently treats the liability as a nonrecourse partnership liability. Such grandfathered debt continues to be treated as nonrecourse debt even if a partner or related party subsequently assumes the economic risk of loss with respect to the debt.

ALLOCATIONS MADE WITH RESPECT TO CONTRIBUTED PROPERTY

IRC Sec. 704(c)(1)(A) provides that taxable income, gain, loss, and deduction must be allocated among partners to take into account the differences between the FMV of property contributed to a partnership and the property's tax basis at the time of contribution. A common misconception is that the Section 704(c) rules apply only to property with precontribution gain and only to hard assets such as real estate and equipment. In fact, IRC Sec. 704(c) applies to any property contributed by a partner if there is a difference between its FMV and tax basis at the time of contribution. IRC Sec. 704(c) applies to items such as precontribution loss property, unrealized receivables of a cash basis taxpayer, and appreciated inventory.

The regulations provide that if a partnership disposes of Section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property is treated as Section 704(c) property with the same amount of built-in gain or loss as the Section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. If a partnership transfers an item of Section 704(c) property together with other property to a corporation under IRC Sec. 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the Section 704(c) property is determined as if each item of Section 704(c) property had been the only property transferred to the corporation by the partnership. If a partner contributes a contract that is Section 704(c) property to a partnership, and the partnership subsequently acquires property pursuant to that contract in a transaction in which less than all of the gain or loss is recognized, the acquired property is treated as the Section 704(c) property. For this purpose the term contract includes, but is not limited to, options, forward contracts, and futures contracts. The allocation method for the acquired property must be consistent with the allocation method for the contributed contract.

If any contributed property has a built-in loss (i.e., its adjusted basis exceeds its FMV), the built-in loss is taken into account only in determining the amount of items allocated to the contributing partner. Except as provided in regulations, in determining the amount of items allocated to the other partners, the basis of the contributed property in the hands of the partnership is deemed to be its FMV at the time of contribution.

In Ltr. Rul. 200829023 the IRS indicated that the use of a last-in, first-out (LIFO) methodology was an acceptable allocation method under Reg. 1.704-3(a)(8) when a partnership transferred property in a Section 1031 like-kind transfer in which cash was received as boot. The partnership allocated the gain that resulted from the boot in the following order: (a) according to Section 704(b) book gain; (b) to partners whose capital accounts had been increased to reflect post-contribution gain resulting from the prior revaluations of the relinquished Section 704(c) property on a LIFO basis; and (c) to the contributing Section 704(c) partner.

Abusive Transactions Involving Liability Assumptions

Regulations address abusive transactions involving the contribution of liabilities to a partnership and subsequent disposition of the partnership interest. These transactions accelerate or duplicate losses through the assumption of (or transfer of assets subject to) liabilities. An example of such an arrangement involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that debt. For example, a taxpayer may receive $5,000 cash from a lender under a loan agreement that provides a stated principal amount of $4,000 and an inflated rate of interest. The taxpayer contributes the $5,000 to a partnership and the partnership assumes the $4,000 debt. At a later time the taxpayer sells his partnership interest. The taxpayer claims that only the $4,000 principal amount of the debt is assumed by the partnership, resulting in the taxpayer having a basis in his partnership interest of $1,000—the $5,000 cash contributed, less the $4,000 deemed distribution of cash from the assumption of the taxpayer's debt by the partnership. Upon disposition, the taxpayer claims a loss of $1,000, even though he has incurred no corresponding economic loss. In another variation of this transaction, taxpayers use put and call options to achieve substantially the same result.

The regulations prevent the duplication and acceleration of loss through the assumption by a partnership of a Reg. 1.752-7 liability from a partner. A Reg. 1.752-7 liability is defined as any fixed or contingent liability that is not described in Reg. 1.752-1(a), to the extent that either the obligation is not described in that regulation, or the amount of the obligation exceeds the amount taken into account under Reg. 1.752-1(a)(4)(i). Reg. 1.752-1(a)(4)(ii) defines an obligation as any fixed or contingent obligation to make payment regardless of whether the obligation is otherwise taken into account under the Internal Revenue Code. Obligations include debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. Reg. 1.752-1(a)(4)(i) provides that an obligation is a liability for the purposes of IRC Sec. 752 only if and to the extent the obligation:

a. creates or increases the basis of any of the obligor's assets (including cash);

b. gives rise to an immediate deduction to the obligor; or

c. gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital (such as a penalty or the nondeductible portion of meals and entertainment expenses).

The amount of a Reg. 1.752-7 liability or obligation is the amount of cash a willing assignor would pay a willing assignee to assume the liability or obligation in an arm's-length transaction. If the obligation arose under a contract in exchange for rights granted to the obligor under that contract, and those rights are contributed to a partnership in connection with its assumption of the contractual obligation, the amount of the liability or obligation is the amount of cash a willing assignor would pay a willing assignee to assume the whole contract. A partner's share of a partnership Reg. 1.752-7 liability is the amount of the deduction that would be allocated to the partner if the partnership disposed of all of its assets, satisfied all its liabilities other than Reg. 1.752-7 liabilities, and paid an unrelated person to assume all of its Reg. 1.752-7 liabilities in a fully taxable arm's-length transaction (assuming such payment would give rise to an immediate deduction).

The regulations address how Reg. 1.752-7 liabilities are treated when they are assumed by a partnership as part of a tax-free contribution by a partner, when a partner other than the contributing partner assumes part or all of the

liability from the partnership, and when the contributing partner subsequently sells or exchanges all or part of his partnership interest or receives a distribution in liquidation of his partnership interest. The regulations prevent the duplication of loss by prohibiting the partnership and any person other than the contributing partner from claiming a deduction or capital expense to the extent of the built-in loss associated with the obligation. The regulations also prevent the acceleration of loss by deferring the contributing partner's deduction or loss attributable to the obligation until economic performance occurs. It is important to note that, under certain circumstances, the subsequent transfer of the contributor's partnership interest, the liquidation of the contributor's partnership interest, or the assumption of the transferred liability by another partner does not trigger the application of the Reg. 1.752-7 rules.

The first exception applies if a partnership assumes a Reg. 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business. If a partnership (upper-tier entity) assumes a Reg. 1.752-7 liability of a partner, and, subsequently, another partnership or LLC (lower-tier entity) assumes that Reg. 1.752-7 liability from the upper-tier entity, then the Reg. 1.752-7 liability is treated as associated only with any trade or business contributed to the upper-tier entity by the contributing partner.

The second exception applies when immediately before the testing date, the remaining built-in loss with respect to all Reg. 1.752-7 liabilities assumed by the partnership (except those assumed in connection with an associated trade or business) in one or more Reg. 1.752-7 liability transfers is less than the lesser of 10% of the partnership's gross value or $1 million. The testing date is the date of a sale, exchange, or other disposition of part or all of the Reg. 1.752-7 liability partner's interest; the date of the partnership's distribution in liquidation of the Reg. 1.752-7 liability partner's interest; or the date of the assumption (or partial assumption) of the Reg. 1.752-7 liability by a partner other than the Reg. 1.752-7 liability partner.

Treatment as Section 704(c) Item of Built-In Loss. When a partnership assumes a partner's liability in connection with a contribution of property to the partnership, the liability assumed is treated as having a built-in loss under the rules of IRC Sec. 704(c). The amount of the built-in loss is the amount of the Reg. 1.752-7 liability on the date it is assumed by the partnership. Consequently, items of deduction or loss with respect to the liability must be allocated first to the contributing partner to the extent of the built-in loss. Remaining deductions or losses are allocated among the other partners based on the Section 704(b) allocation rules.

A decrease or increase in the value of a Reg. 1.752-7 liability after it is contributed to the partnership is an item of income or loss if it is reflected in the partners' capital accounts. This income or loss is allocated among the partners based on the general rules for allocating income and loss outlined in IRC Sec. 704(b).

Tiered Ownership Structures. A contribution by a partner of an interest in a partnership (lower-tier entity) to another partnership (upper-tier entity) is treated as a contribution of the partner's share of each of the lower-tier entity's assets and an assumption by the upper-tier entity of the partner's share of the lower-tier entity's liabilities. If an upper-tier entity assumes a Reg. 1.752-7 liability of a partner, and subsequently, a lower-tier entity assumes that liability, the liability is treated as associated only with any trade or business contributed to the upper-tier entity by a contributing partner.

ALLOCATING CREDITS PROPERLY

Tax credits generally do not affect a partner's rights to cash distributions or cash upon liquidation. Therefore, an allocation of a tax credit cannot have substantial economic effect and the tax credit must be allocated in accordance with the partners' interests in the partnership (PIP).

For investment tax credits governed by IRC Sec. 38 (primarily the rehabilitation tax credit), allocations of the credit to the partners under the rules of Reg. 1.46-3(f) are treated as being in accordance with the partners' interests in the partnership. Under this general rule, investment tax credits are shared based on the way partners share the partnership's profits. However, if all items of income, gain, loss, and deduction with respect to an item of Section 38 property are specially allocated, each partner's share of the related credit is shared based on the special allocation. The sharing ratios that govern the allocation of investment tax credits are those in effect during the tax year the Section 38 property is placed in service. If sharing ratios change during the year, the ratios in effect on the date the

property is placed in service will govern. If there is a basis adjustment that is associated with an investment tax credit, the basis adjustment is treated as an economic loss and is allocated to, and reduces the book capital account of, the partners that receive the allocation of the credit (with an increase in the applicable partners' capital accounts for basis recovered on recapture of the credit).

With respect to tax credits other than those arising under IRC Sec. 38, if a partnership expenditure giving rise to a tax credit also gives rise to a valid allocation of partnership loss or deduction (whether or not tax deductible), the related credit is allocated to the partners receiving the loss or deduction for book purposes in the same proportion.

Example 3-11: Allocating tax credits to partners.

Buck and Bama are equal general partners in BB Partnership which develops low-income housing. BB partnership and profits are split 50/50 between the two partners with the depreciation and low income housing credit specially allocated 99% to Bama and 1% to Buck. This allocation of deprecation is determined to have substantial economic effect. Therefore, the allocation of the low-income housing credit in the same 99%/1% split will be respected.

ALLOCATING FOREIGN TAXES PROPERLY

Allocations of creditable foreign taxes do not have substantial economic effect, and are thus allocated in accordance with the partners' interests in the partnership (PIP). An allocation of a creditable foreign tax expense will be deemed to be in accordance with PIP if—

a. The creditable foreign tax expense is allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the creditable foreign tax expense relates; and

b. Allocations of all other partnership items that, in the aggregate, have a material effect on the amount of the creditable foreign tax expenses allocated to a partner under the previous item are valid.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. What term matches the following definition?

    A partnership liability for which no economic risk of loss is borne by any partner or related person.

    a. Nonrecourse deduction.

    b. Nonrecourse liability.

    c. Minimum gain.

    d. Minimum gain chargeback.

37. Minimum gain could arise from which of the following scenarios?

    a. Principal of one of Uno Partnership's nonrecourse liabilities is paid down.

    b. Property that Dos Partnership uses to secure a nonrecourse debt is revalued in an optional bookup.

    c. Depreciation of a piece of Tres Partnership's property causes its book basis to sink below the amount of nonrecourse liability the property secures.

    d. A previous nonrecourse liability of Cuatro Partnership has been converted into a recourse liability.

38. The Zeta Partnership has a net decrease in partnership minimum gain during the current tax year. How would each partner's share be calculated?

    a. The year's net decrease is multiplied by the partner's percentage interest in the total partnership minimum gain at the end of the immediately preceding tax year.

    b. The excess of total nonrecourse deductions allocated to each partner to date is added to the total distributions of nonrecourse liabilities proceeds allocated to the partner to date.

    c. The excess of total minimum gain decrease allocated to each partner to date is added to the total minimum gain decrease from revaluations of the partnership property that have been allocated to the partner to date.

39. Which of the following statements about allocations of contributed property is the most accurate?

    a. The rules found in IRC Sec. 704(c) only apply to hard assets, such as real estate, and property with precontribution gain.

    b. If Section 704(c) property is disposed of in a nonrecognition transaction and no gain or loss is recognized, the substituted basis property is treated as Section 704(c) property.

    c. Any allocation method can be used for substituted basis property.

    d. If contributed property has built-in loss, the loss is taken into account to determine the property's FMV.

40. Tax credits and foreign taxes should be allocated in accordance with what method?

    a. The safe harbor rules.

    b. The partners' interests in the partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

36. What term matches the following definition? **(Page 178)**

    A partnership liability for which no economic risk of loss is borne by any partner or related person.

    a. Nonrecourse deduction. [This answer is incorrect. Nonrecourse deductions are deductions that produce minimum gain.]

    b. Nonrecourse liability. [This answer is correct. Nonrecourse liabilities are defined by cross-reference to the regulations under IRC Sec. 752.]

    c. Minimum gain. [This answer is incorrect. Minimum gain is the excess of nonrecourse liabilities secured by partnership property over the book basis of the collateral property.]

    d. Minimum gain chargeback. [This answer is incorrect. This is the allocation of minimum gain based on the amount of previously allocated nonrecourse deductions.]

37. Minimum gain could arise from which of the following scenarios? **(Page 181)**

    a. Principal of one of Uno Partnership's nonrecourse liabilities is paid down. [This answer is incorrect. In this scenario, Uno Partnership's minimum gain would have decreased.]

    b. Property that Dos Partnership uses to secure a nonrecourse debt is revalued in an optional bookup. [This answer is incorrect. Under these circumstances, Dos Partnership's minimum gain would have decreased.]

    c. Depreciation of a piece of Tres Partnership's property causes its book basis to sink below the amount of nonrecourse liability the property secures. [This answer is correct. According to the IRS regulations, a partnership's minimum gain is the total minimum gain for all partnership property subject to nonrecourse liabilities. Minimum gain usually arises in one of two ways (1) the depreciation or amortization of property causes the book basis to fall below the amount of the nonrecourse liability secured by the property and (2) the partnership refinances the property (or obtains a second mortgage), and as a result, the amount of the nonrecourse liability exceeds the book basis of the property securing the nonrecourse liability.]

    d. A previous nonrecourse liability of Cuatro Partnership has been converted into a recourse liability. [This answer is incorrect. Cuatro Partnership's minimum gain would have decreased in this scenario.]

38. The Zeta Partnership has a net decrease in partnership minimum gain during the current tax year. How would each partner's share be calculated? **(Page 181)**

    a. The year's net decrease is multiplied by the partner's percentage interest in the total partnership minimum gain at the end of the immediately preceding tax year. [This answer is correct. Under the regulations, this is the correct way to make the calculation. The term partner, in this case, includes both the current partners and the partner's predecessors in interest.]

    b. The excess of total nonrecourse deductions allocated to each partner to date is added to the total distributions of nonrecourse liabilities proceeds allocated to the partner to date. [This answer is incorrect. Under the regulations, this is a portion of the calculation of a partner's share of total partnership minimum gain at the end of the year.]

    c. The excess of total minimum gain decrease allocated to each partner to date is added to the total minimum gain decrease from revaluations of the partnership property that have been allocated to the partner to date. [This answer is incorrect. This is part of the calculation of a partner's share of total partnership minimum gain at the end of the tax year, per the regulations.]

39. Which of the following statements about allocations of contributed property is the most accurate? **(Page 184)**

    a. The rules found in IRC Sec. 704(c) only apply to hard assets, such as real estate, and property with precontribution gain. [This answer is incorrect. This is a common misconception. In fact, IRC Sec. 704(c) applies to any property contributed by a partner if there is a difference between its FMV and tax basis at the time of contribution.]

    b. If Section 704(c) property is disposed of in a nonrecognition transaction and no gain or loss is recognized, the substituted basis property is treated as Section 704(c) property. [This answer is correct. The regulations provide that if a partnership disposes of Section 704(c) property in this manner, the substituted basis property is treated as Section 704(c) property with the same amount of built-in gain or loss as the Section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made.]

    c. Any allocation method can be used for substituted basis property. [This answer is incorrect. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property, under the Code.]

    d. If contributed property has built-in loss, the loss is taken into account to determine the property's FMV. [This answer is incorrect. Under the Code, if any contributed property has built-in loss (i.e., its adjusted basis exceeds its FMV), the built-in loss is taken into account only in determining the amount of items allocated to the contributing partner.]

40. Tax credits and foreign taxes should be allocated in accordance with what method? **(Page 186** and **Page 187)**

    a. The safe harbor rules. [This answer is incorrect. Under the regulations, neither tax credits nor foreign taxes have substantial economic effect; therefore, they do not qualify to use the safe harbor rules.]

    b. The partners' interests in the partnership. [This answer is correct. Tax credits generally do not affect a partner's rights to cash distributions or cash upon liquidation. Therefore, according to the regulations, an allocation of a tax credit cannot have substantial economic effect and the tax credit must be allocated in accordance with the partners' interests in the partnership. Additionally, according to the regulations, allocations of creditable foreign taxes do not have substantial economic effect, and are thus allocated in accordance with the partners' interests in the partnership.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (TPSTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

23. Which of the following partnerships can make an optional revaluation of all partnership property under the safe harbor rules?

    a. Rebeckah contributes property and cash to the Alston Partnership in exchange for a partnership interest.

    b. The Kinch Partnership's property is primarily stock, securities, commodities, options, and money.

    c. The Newton Partnership grants a de minimis interest to Sam in exchange for services provided to the partnership.

    d. Interest in exchange.

24. If one of the partnerships in the previous question qualifies for an optional revaluation of property under the safe harbor rules, where could the language providing for the revaluation be included?

    a. In a written election attached to the partnership's tax return.

    b. In a written election attached to the partners' tax returns.

    c. In the original partnership agreement.

    d. In an amendment to the partnership agreement filed by the due date of the partnership's tax return, including extensions.

25. The Blankman Partnership accepts a new member and elects to revalue all partnership assets for book capital account purposes. Which of the following is an applicable revaluation procedure according to the regulations?

    a. The adjustments will be made based on the property's tax basis on the revaluation date.

    b. The partnership treats the property as sold and subtracts the FMV of the property from the property's book capital account to recognize gain or loss.

    c. The safe harbor regulations must be used to calculate book depreciation, amortization, depletion, and subsequent book gain or loss upon disposition of revalued property.

    d. Any book/tax difference created by the revaluation affects the amount of tax depreciation, amortization, depletion, and gain or loss, as well as the allocation of such items.

26. If a new partner contributed nondepreciable property with built-in gain, would it be better for the partnership to revalue or not to revalue?

    a. Revalue.

    b. Not revalue.

    c. As long as the property at least holds its value, there are no economic consequences associated with either decision.

    d. Do not select this answer choice.

27. Sarah and Dawn form a partnership at the beginning of 2010. Sarah contributes $20,000 cash, and Dan contributes a piece of depreciable equipment that has a $12,000 tax basis. The cost recovery method is straight-line with a remaining five-year life. (The equipment will be fully depreciated by the end of 2014.) The partnership's income is equal to its operating expenses other than depreciation. The partnership agreement complies with the safe harbor regulations and, except as otherwise provided, provides for a 50/50 split of all partnership items. Sarah agrees to accept Dawn's belief that the property is worth $20,000. This agreement makes annual book depreciation expense $4,000. The partnership allocates tax depreciation to Sarah that is equal to her book depreciation, and allocates the rest to Dawn. By what year will the partnership have eliminated the book/tax difference?

    a. 2012.

    b. 2013.

    c. 2014.

    d. 2015.

28. Scott and Sandra form a partnership. Scott contributes $500 cash, and Sandra contributes a nondepreciable asset with $500 FMV and a $300 tax basis. They have equal economic interest in partnership profits and losses. Under the safe harbor book capital account rules, they each have opening book capital accounts of $500. The asset decreases in value to $450, and the partnership sells it. This gives the partnership a $50 economic loss, but a $150 tax gain. Calculate each partner's ending tax basis.

    a. Scott: $25; Sandra $175.

    b. Scott: $450; Sandra $500.

    c. Scott: $500; Sandra $450.

    d. Scott: $500; Sandra $500.

29. According to the regulations, which of the following can be used to make allocations under IRC Sec. 704(c)?

    i. The traditional method.

    ii. The traditional method with curative allocations.

    iii. The remedial method.

    iv. The ceiling rule.

    v. Any other reasonable method.

    a. i., ii., and iii.

    b. i., ii., iii., and iv.

    c. i., ii., iii., and v.

    d. i., ii., iii., iv., and v.

30. The Mutual Partnership is a management company registered with the Securities and Exchange Commission under the Investment Company Act of 1940. Can it aggregate gains and losses when making reverse Section 704(c) elections?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

31. Match the following terms with the appropriate definitions.

Terms	Definitions
1. Traditional method	i. In certain situations, partnerships can allocate phantom income or gain that was created by the partnership to noncontributing partners with offsetting allocations of loss or deduction that were created by the partnership to the contributing partner.
2. Traditional method with curative allocations	ii. Tax allocations only. They are reasonable only so far as they do not exceed the amount needed to offset the effect of the ceiling rule for the current tax year (or prior tax years when made for disposition of the property).
3. Curative allocations	iii. Partnerships must allocate gain or loss upon the disposition of contributed property in a way that ensures the contributing partner is allocated any precontribution gain or loss. Cost recovery deductions related to contributed property must be allocated so that built-in gain or loss is reduced as quickly as possible.
4. Remedial allocation method	iv. Partners can overcome distortions caused by the ceiling rule by making curative allocations of other partnership items of income or expense.

a. 1., iv.; 2., iii.; 3., i.; 4., ii.

b. 1., iii.; 2., iv.; 3., ii.; 4., i.

c. 1., ii.; 2., i.; 3., iv.; 4., iii.

d. 1., i.; 2., ii.; 3., iii.; 4., iv.

32. The ceiling rule is applicable to all Section 704(c) allocations, **except** those made under which method?

a. Traditional method.

b. Traditional method with curative allocations.

c. Remedial allocation method.

d. Do not select this answer choice.

33. Darren contributes property with built-in gains to the Duo Partnership. The partnership has one other partner—Lisa. Which allocation method would be most advantageous to Darren?

a. Traditional method.

b. Traditional method with curative allocations.

c. Remedial allocation method.

d. Undivided interests method.

34. Assume the same facts about the Duo Partnership as in the previous question. Which allocation method would be most advantageous to Lisa?

    a. Traditional method.

    b. Traditional method with curative allocations.

    c. Remedial allocation method.

    d. Oil and gas method.

35. In 2010, the Rapid Turnover Partnership undergoes a technical termination. To whom will the Section 704(c) rules apply?

    a. They apply to all partners of the old partnership.

    b. They apply to all partners of the new partnership.

    c. They apply to all continuing partners in the new partnership.

    d. They apply to all partners associated with the old and new partnership.

36. In which of the following scenarios, can a decrease in minimum gain occur without the application of the minimum gain chargeback rule?

    a. Don is allocated a recourse loss that would result in a negative capital account. He does not have an obligation to restore a deficit capital account, and his partnership does not have a qualified income offset provision.

    b. Mary makes a contribution to the partnership that decreases the basis of property subject to a nonrecourse liability.

    c. The partners vote to waive the requirement because it would result in a distortion of the economic agreement that had been previously accepted by the partners.

    d. Due to refinancing, a decrease results from the conversion of nonrecourse debt to recourse debt, and Helen bears the economic risk of loss with regard to the newly refinanced debt.

37. Which of the following partnerships is **not** allocating its nonrecourse deductions under the safe harbor rules assuming all of the other requirements are met?

    a. Single Partnership maintains book capital accounts in accordance with the partners' interests in the partnership and the liquidations are in accordance with the capital accounts.

    b. Double Partnership allocates nonrecourse deductions among partners consistently with allocations of another significant partnership item that has substantial economic effect and is related to the property that secures the nonrecourse liability.

    c. Triple Partnership has a minimum gain chargeback provision in its partnership agreement.

    d. Quadruple Partnership makes sure all other material allocations and capital account adjustments that are made under the partnership agreement will be recognized under the safe harbor regulations.

38. Which of the following partnerships correctly addresses an aspect of nonrecourse liabilities?

    a. The Summer Partnership distributes nonrecourse liability proceeds to its partners and treats the distribution as a decrease in partnership minimum gain.

    b. Kara bears the economic risk of loss with respect to a liability of the Autumn Partnership. The partnership treats Kara's associated deduction as a nonrecourse deduction.

    c. The Winter Partnership assigns personal liability of all exculpatory liability to its partners.

    d. The Spring Partnership's tax years began on January 1, 1995, so it uses the final set of nonrecourse deduction allocation regulations.

39. Jack borrows $10,000 cash from a lender. His loan agreement provides a stated principal amount of $8,000 and an inflated rate of interest. Jack contributes the $10,000 to the Island Partnership, and the partnership assumes the $8,000 debt. The next year, Jack sells his partnership interest and claims that only the $8,000 principal amount of the debt is assumed by the partnership, resulting in Jack having a basis of $2,000 in his partnership interest. Upon disposition, Jack claims a loss of $2,000. Is this a valid transaction?

    a. Yes, Jack should be able to claim this loss.

    b. No, this is an abusive transaction.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

40. Which partnership has correctly dealt with an issue regarding allocations of tax credits or foreign taxes?

    a. The Blue Partnership has investment tax credits under IRC Sec. 38. During the year, the sharing ratios change. The partnership uses the ratios in place at the end of the year.

    b. The Green Partnership has an expenditure that gives rise to both a tax credit and a loss allocation. This credit is allocated to the partners who received the loss for book purposes in the same proportion.

    c. The Purple Partnership plans to allocate creditable foreign taxes in accordance with its partners' interests. However, these taxes are not reported on the partnership return and a material allocation that affects the creditable foreign tax is invalid.

    d. Do not select this answer choice.

GLOSSARY

Ceiling rule: This is an important limitation on a partnership's ability to allocate income, gain, loss, and deduction among the partners. It provides that the amount of income, gain, loss, and deduction that can be allocated to a partner for tax purposes cannot exceed 100% of the amount of such item that the partnership actually recognizes for tax purposes.

Curative allocations: These are tax allocations only and do not result in any related economic allocations. They are reasonable only to the extent they do not exceed the amount necessary to offset the effect of the ceiling rule for the current tax year, or, in the case of a curative allocation upon disposition of the property, for prior tax years. They are reasonable only if the items allocated have the same tax effect on the partners as the items affected by the ceiling rule.

Economic effect: The first element of the substantial economic effect safe harbor rules. For a tax allocation to have economic effect under the safe harbor rules it must meet two requirements: (1) the underlying economic arrangement of the partners must be maintained and accounted for under the detailed capital account maintenance rules contained in the regulations, and (2) the tax allocation must be consistent with the underlying economic arrangement of the partners.

Minimum gain: The excess of nonrecourse liabilities secured by partnership property over the book basis of the collateral property. It is determined by reference to the book basis of property, not tax basis.

Nonrecourse deduction: Losses related to nonrecourse liabilities.

Nonrecourse liability: Any partnership liability for which no partner or related person bears any economic risk of loss.

Oil and gas method: An allocation that may be reasonable for Section 704(c) allocations. Under this method, each partner is, in essence, allocated all of the depreciation or depletion from each item of property the partner contributes to the partnership (or from property purchased with cash contributed by the partner).

Partnership agreement: Generally, partnerships have a written partnership agreement that sets out the partners' duties and the allocation to those partners of the partnership's tax and economic items. In addition to the actual document itself, the regulations provide that the partnership agreement also includes all oral and written agreements among the partners, or between one or more partners and the partnership, concerning the partnership's affairs. Also, the agreement includes federal, state, and local law governing the partnership's affairs.

Partners' interests in the partnership (PIP) rules: Tax allocations must be made to reflect the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the taxable income, gain, loss, deduction, or credit that is allocated.

Remedial allocation method: Under this method, the partnership can, in certain situations, make tax allocations of phantom income or gain created by the partnership to noncontributing partners, with offsetting allocations of loss or deduction created by the partnership to the contributing partner. Remedial allocations are allowed only when there is a book allocation to a noncontributing partner that is different from the tax allocation to that partner.

Shifting allocation: A shifting tax consequence occurs when (1) the net increases and decreases in the partners' book capital accounts for the tax year are substantially what they would have been if the allocations were not made and (2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement (taking into account each partner's tax attributes). If a shifting allocation occurs, there is a presumption that the allocation is insubstantial, but it can be overcome.

Special tax allocation: An allocation of income, gain, loss, deduction, or credit among the partners that is not in proportion with their ownership interest.

Substantial allocation: The second element of the substantial economic safe harbor rules. An allocation is substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts to be received by the partners, independent of tax considerations.

Substantial economic effect safe harbor rules: Complicated rules set forth by the IRS to ensure that special partnership tax allocations are not made in an artificial or abusive manner. The purpose of these rules is to provide a uniform system of bookkeeping for the economic results of partnership operations. Once the economic bookkeeping has been done to accurately reflect the partners' real economic agreement, the tax allocations must be made in a manner consistent with the way the economic results of operations have been allocated among the partners.

Technical termination: A partnership is considered to terminate for tax purposes if 50% or more of the total interests in partnership capital and profits are sold or exchanged within a 12-month period. The old partnership is deemed to contribute all its assets and liabilities tax-free under IRC Sec. 721 to a new partnership in exchange for 100% ownership of the new partnership.

Traditional method: This method is described in Reg. 1.704-3(b). It requires the partnership to allocate any gain or loss upon the disposition of contributed property in a manner that ensures the contributing partner is allocated any precontribution gain or loss. These rules also provide that any cost recovery deductions (depreciation, depletion, or amortization) with respect to contributed property must be allocated in the manner that most rapidly reduces the built-in gain or loss associated with the contributed property.

Traditional method with curative allocations: This allocation method allows partners to overcome the distortions caused by the application of the ceiling rule by making curative allocations of other partnership items of income and expense.

Undivided interests method: Prior to the amendment in 1984, this method was a specifically stated method under IRC Sec 704(c). Under this method, allocations of depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership were determined as though the undivided interests had not been contributed to the partnership. This method is not specifically identified in the final regulations because it has limited application.

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COMPANION TO PPC'S TAX PLANNING GUIDE—PARTNERSHIPS

COURSE 3

CONTRIBUTIONS OF PROPERTY & SERVICES (TPSTG103)

OVERVIEW

COURSE DESCRIPTION: Lesson 1 of this course covers contributions of property and addresses aspects of the nonrecognition rule, disguised sale rules, and a variety of contributions to the partnership such as partnership debt, promissory notes, zero-basis receivables, appreciated or depreciated property, long-term contracts, and appropriate assets. Lesson 2 covers contributions of services and deals with issues such as understanding the tax treatment of a service partner, and valuing partnership interests acquired in exchange for services.

PUBLICATION/REVISION DATE: April 2010

RECOMMENDED FOR: Users of *PPC's Tax Planning Guide—Partnerships*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of preparing Form 1065, *U.S. Return of Partnership Income*

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **April 30, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Contributions of Property

Completion of this lesson will enable you to:
- Recognize how property contributions to partnerships are handled.
- Identify exceptions to the nonrecognition of gain or loss rule.
- Define disguised sale rules and how they are applied.
- Determine the effect of contributing partnership debt, promissory notes, zero-basis receivables, and appreciated or depreciated property.
- Identify accounting for depreciation and depreciation recapture, taxing noncompensatory options, and contributing assets.

Lesson 2—Contributions of Services

Completion of this lesson will enable you to:
- Define the factors that affect the tax treatment of a service partner.

- Identify the benefits and risks of a Section 83(b) election.
- Determine how to value partnership interests acquired in exchange for services and the associated tax consequences.

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Lesson 1: Contributions of Property

INTRODUCTION

The creation and operation of a partnership usually involves transfers of money and property from the partners to the partnership. For the most part, the Code provides favorable tax treatment for such transfers. In fact, the benefits of nonrecognition treatment are more widely available for property contributions to a partnership than for property contributions to a corporation. In corporate settings, nonrecognition of gain applies only if the contributor, together with any simultaneous contributors, controls the corporation immediately after the contribution. Control requires that the contributors to the corporation own 80% of the voting power in the corporation and 80% of the total number of shares of all other classes of the corporation's stock.

The business purpose rule of IRC Sec. 7701(a)(2) requires that partnerships be established for a valid business, investment, or income-producing purpose, and not merely for personal reasons. (As a practical matter, this issue most often arises with family partnerships.) The types of assets transferred to the partnership will usually indicate whether the partnership has a valid business purpose. Assets that are clearly held for business or investment purposes are suitable for placement in a partnership.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize how property contributions to partnerships are handled.
- Identify exceptions to the nonrecognition of gain or loss rule.
- Define disguised sale rules and how they are applied.
- Determine the effect of contributing partnership debt, promissory notes, zero-basis receivables, and appreciated or depreciated property.
- Identify accounting for depreciation and depreciation recapture, taxing noncompensatory options, and contributing assets.

MAKING CERTAIN THAT CONTRIBUTIONS RECEIVE NONRECOGNITION TREATMENT

As a general rule, no gain or loss is recognized on a contribution of money or unencumbered property to a partnership. This is true whether the contribution occurs at the time of formation or on a later date. In the partnership setting, there is no requirement that the contributor(s) control the organization after the contribution. The recipient partnership recognizes no gain or loss on the receipt of contributed property from a partner. This ability to contribute property to partnerships on a tax-free basis, coupled with the ability to, in many instances, distribute property from partnerships without recognition of gain or loss by the partner or the partnership, is often a significant reason for conducting a business venture in the partnership form.

Example 1-1: Contributing property to a partnership in a nontaxable transaction.

On March 15, Stan and Ollie formed S&O Development Co. (S&O), an equal general partnership, to develop two adjacent tracts of real estate. Stan contributed Tract 1, with a $50,000 FMV and a $35,000 basis. Ollie contributed Tract 2, with a $50,000 FMV and a $55,000 basis. Neither tract is subject to any indebtedness.

On September 15, after S&O's assets have increased in value to $200,000, Buster is admitted as a new partner with a one-third interest. Stan's and Ollie's interests are reduced proportionately. Buster contributes two tracts of land adjacent to S&O's property. Buster's land is not subject to any liabilities and has a $100,000 FMV and a $65,000 basis. No subsequent distributions are anticipated that would make any of the contributions subject to the disguised sale rules. Will Stan, Ollie, or Buster recognize gain or loss on their contributions to S&O?

A contributing partner recognizes no gain or loss on the contribution of property if the property is not subject to liabilities and the partnership assumes no liabilities in connection with the transaction. Thus, Stan, Ollie,

and Buster do not recognize gain or loss on their contributions to S&O. After the contribution, S&O has a $35,000 basis in Tract 1 and a $55,000 basis in Tract 2. Those amounts also are Stan's and Ollie's initial bases in their partnership interests. Buster recognizes no gain or loss on his contribution to S&O.

Determining the Timing and Valuation of Property Contributions

Frequently, the timing and valuation of a capital contribution is difficult to determine. Accordingly, the partners may want to address the timing and valuation of capital contributions in the partnership agreement or in a separate contribution agreement. In the case of a property contribution, it is normally easy to determine the timing of the contribution, since some legal documentation of the transfer is usually required. However, the value of a property contribution is not always readily ascertainable. To prevent the IRS from questioning the valuation of a contribution, the partners should specify a reasonable method they have agreed to for valuing the contribution. Providing a reasonable method can also head off challenges by creditors concerning the value of contributed property. The valuation method may be, but does not have to be, based on an appraisal.

Documenting a Contribution

Documentation of capital contributions is important. Most state statutes enforce only written contribution obligations. Accordingly, the terms of each capital contribution should be in writing, signed by both the partnership and the partner/contributor and should include the following:

a. Name, address, and EIN of the partner and the partnership.

b. Description of the property, services, etc., to be contributed.

c. The value of the property and the method used to determine the value.

d. The date the contribution is deemed to be made.

e. The percentage interest in the partnership received for the contribution.

f. Any liabilities assumed in connection with the contribution.

g. Any other conditions or terms agreed to by the parties.

h. Written transfer document, where appropriate (for example, an assignment of title).

i. Whether the contributor or the partnership will be responsible for payment of transfer fees and other costs related to the contribution.

j. Any warranties and representations required to be made by the contributor regarding the contributed property.

k. Whether the partnership requires an inspection of the contributed property.

l. The acceptance of the contribution by the partnership.

m. The adjusted basis of the property (including any accumulated depreciation subject to recapture under IRC Sec. 1245 or 1250.

n. Details regarding any built-in gain or loss upon contribution of the property.

Copies of the contribution agreements should be maintained as part of the partnership's permanent records.

Recognizing When Gain or Loss Recognition Is Desirable

While nonrecognition treatment is usually desired, a practitioner may encounter circumstances in which a partner wishes to recognize gain or loss on the transfer of property to a partnership. For example, a partner with a net

operating loss during the year of contribution might not object to recognizing gain on the transfer of property to a partnership. The partnership's taxable acquisition would result in an increase in the property's basis, which, if the property is depreciable, in turn would yield increased depreciation deductions in the future. Another situation in which it may be beneficial to trigger a taxable transaction is when the contributed property has depreciated in value, and the partner wishes to recognize a loss. In these situations, the practitioner might suggest that the partner contribute cash instead of contributing property, and then sell the property to the partnership.

As a general rule, gain or loss on sales by partners to partnerships is recognized, but special rules may limit the ability of a partner owning a substantial interest to recognize a loss or to recognize gain as capital gain (rather than ordinary income) in such transactions.

Underwriting Limited Partner Interests

In some cases, offerings of limited partnership interests are underwritten by securities firms. In essence, the underwriter collects the cash contributions by the investing limited partners and handles the issuance of the limited partner interests. After deducting their fees, the underwriter passes along the contributions to the limited partnership, and business proceeds as usual. The existence of an underwriter is ignored in "qualified" underwriting transactions for tax purposes. In other words, the investor limited partners are treated as making contributions directly to the limited partnership rather than as engaging in some sort of transaction with the underwriter.

Neither the contributor nor the partnership recognizes gain or loss. The partnership acquires a basis in the contributed property equal to the contributor's basis. The contributor's basis in the partnership interest is increased by the basis of the contributed property.

Contributed Property in the Hands of the Partnership

A partnership that receives contributions of property must establish the basis, the holding period, and the character of the property in the hands of the partnership, and also determine available accounting and depreciation methods.

Determining the Basis of Contributed Property to the Partnership

IRC Sec. 723 provides that a partnership's basis in contributed property is generally the contributing partner's adjusted tax basis in the property, plus any gain the partner recognizes under the investment company rules. In addition, if the contributing partner recognizes gain from the relief from liabilities, the partnership may be entitled to a basis step-up. The partnership also receives a higher basis if gain is recognized under the disguised sale rules or under the Section 704(c) rules for contributed property later distributed to another partner. If contributed property has a built-in loss, the built-in loss is taken into account only in determining the amount of items allocated to the contributing partner. Except as provided in regulations, in determining the amount of items allocated to the other partners, the basis of the contributed property in the hands of the partnership is its FMV at the time of contribution.

The IRS issued a coordinated issue paper in April 2007 addressing the use of distressed assets to shift economic losses from a tax indifferent party (usually a foreign taxpayer) to a U.S. taxpayer. These types of transactions involve the transfer of high-basis, low-value assets to a partnership. The coordinated issue paper provides that the contribution of a worthless asset to a partnership does not give rise to any carryover basis; the partnership has no adjusted basis in any asset that was worthless at the time of contribution.

Assessing Partner's Holding Period in Partnership Interests Acquired from Property Contributions

IRC Sec. 1223(2) provides that the partnership's holding period for contributed assets includes the holding period of the assets in the hands of the contributing partner. This tacking-on concept applies whether or not the contributing partner recognizes any gain on the contribution because of a net reduction in liabilities. However, if the contribution is fully taxable because of the investment company rule of IRC Sec. 721(b), the partnership's holding period in the contributed securities begins on the contribution date. Similarly, if the contributing partner recognizes gain under the disguised sale rules, the holding period of the property deemed purchased begins on the contribution date.

A partner's holding period for a partnership interest received in exchange for a contribution of property depends on the character of the contributed property. If the contributed property is a capital asset or property used in a trade or

business (within the meaning of IRC Sec. 1231) immediately prior to the contribution, the partner's holding period for the partnership interest includes the holding period of the contributed property. If the partnership interest is received in exchange for money or other property, the partner's holding period commences on the date the interest is acquired, i.e., the contribution date. The partnership's holding period for the contributed property includes the contributor's holding period.

Example 1-2: Determining a partner's holding period in a partnership interest and the partnership's holding period in contributed property.

On March 1, Louise, Diane, and Mia formed Allenwood Hardware, a general partnership, to conduct a small retail business. Louise contributed cash, Diane contributed equipment that she had owned for two years, and Mia contributed inventory she had acquired three months earlier. Louise is now considering selling her partnership interest to Mia for a profit, and the partnership is considering selling some of the equipment contributed by Diane. What is Louise's holding period for her partnership interest? What is Allenwood Hardware's holding period for the equipment contributed by Diane?

On March 1, Allenwood Hardware has a two-year holding period for the equipment contributed by Diane. Because this holding period exceeds any threshold relevant to a sale of the equipment, the practitioner can advise the partners that an immediate sale would pose no problems.

Because their contributions consisted of cash and inventory, neither of which is a capital asset or Section 1231 property, Louise's and Mia's holding periods for their Allenwood Hardware interests begin March 1—the date of their contribution to the partnership. On that date, Diane has a two-year holding period in the interest she received in exchange for her contribution of Section 1231 property.

Applying the Divided Holding Period Rules. Reg. 1.1223-3 provides guidance relating to the allocation of a divided holding period with respect to a partnership interest. These rules generally provide that the holding period of a partnership interest will be divided if a partner acquires portions of an interest at different times, or if an interest is acquired in a single transaction that gives rise to different holding periods under IRC Sec. 1223. The holding period for that portion of the partnership interest will be determined based on a fraction; the numerator is equal to the FMV of the portion of the partnership interest to which the holding period relates (determined immediately after the acquisition), while the denominator is the FMV of the entire partnership interest.

A divided holding period can create unexpected problems. For example, if a partner makes a cash contribution to a partnership in financial difficulty and the partnership is liquidated shortly thereafter, this regulation can cause the partner to recognize short-term capital gain. However, to circumvent these problems, the regulations provide that when determining the holding period of a partnership interest, if a partner makes one or more contributions of cash to the partnership and receives one or more distributions of cash from the partnership during the one-year period ending on the date of a sale, exchange, or gain-generating distribution, he or she may reduce the cash contributions made by the cash distributions received on a last-in, first-out basis, treating all cash distributions as if they were received immediately before the sale, exchange, or distribution.

This rule also applies in determining the holding period of a partnership interest where gain or loss is recognized under Section 731(a) distributions. This rule does not apply to deemed contributions and distributions resulting from increases and decreases in a partner's share of partnership liabilities. Contributions of Section 751 hot assets within one year of a sale or exchange (but not a distribution) are also disregarded if the partner recognizes ordinary income or loss either as a result of the sale or as the result of a sale of the property by the partnership. However, if the partner does not have a long-term holding period in any portion of his or her partnership interest, this adjustment is not available.

Example 1-3: Sale of a partnership interest with divided holding period.

Annie Apple contributes $50,000 cash to Orchard Management and Investments Partnership. She also contributes orchard equipment used in a trade or business that is held for more than one year. The equipment has a FMV of $100,000 and an adjusted basis of $40,000. The equipment has ordinary recapture potential of $20,000 (which is Section 1245 property). Six months after she acquired her partnership interest, Annie sells it to Patty Plum for $175,000.

It is not completely clear how to determine Annie's holding period in her partnership interest. There seems to be two filing positions because the regulation examples do not specifically address the contribution of recapture property.

The first option is to consider the contributed equipment as a single asset. Under this option, the equipment would be entirely excluded from consideration in determining the holding period for the transferred interest, since it is a Section 751 asset contributed within one year of a qualifying disposition. Because the equipment is excluded, the entire $65,000 gain in excess of the depreciation recapture is considered short-term capital gain.

The second option is to treat the contributed recapture potential as a separate asset from the contributed equipment. This is consistent with the statement in Reg. 1.1223-3(e) that properties and potential gain treated as unrealized receivables under IRC Sec. 751(c) are treated as separate assets that are not capital assets or Section 1231 property. Under this option, Annie has a divided holding period in her partnership interest: $70,000 of the original value of the interest is attributed to assets that are not capital gain or Section 1231 assets (the $50,000 cash plus the $20,000 of recapture). Because the sale occurs within one year of the contribution and the recapture is Section 751 property, the $85,000 gain on the sale would be allocated as follows (because the recapture is not included in the calculation assigning gain to the short-term or long-term category):

Ordinary income—depreciation recapture	$ 20,000
Short-term capital gain [$65,000 × ($50,000/$130,000)]	25,000
Long-term capital gain [$65,000 × ($80,000/$130,000)]	40,000
Total	$ 85,000

Practitioners faced with applying the divided holding period rules to contributions of property subject to depreciation recapture should advise their client of the uncertainty in this area and the approach reflected by the practitioner in the client's tax return.

Determining Accounting Methods

In many instances, an ongoing business will be contributed to a newly formed or existing partnership. This business may use accounting methods different from those the partnership wants to adopt. There is no "carryover" of accounting methods under the provisions of Subchapter K. Therefore, a newly formed partnership (or an existing partnership to which an ongoing business is contributed) elects its own tax accounting methods. A partnership may not be able to use the cash method in certain situations.

Determining Depreciation Methods

The general rule under IRC Sec. 721 is that no gain or loss is recognized on the transfer of property in exchange for an interest in a partnership. When depreciable property is contributed to a partnership, the partnership is treated as if it stepped into the shoes of the transferor partner. The partnership uses the depreciation method and remaining depreciable life used by the transferor. To the extent gain is recognized on the exchange and the basis of the property in the hands of the partnership exceeds the basis in the hands of the transferor, the partnership is treated as if it placed property with a value equal to the basis increase in service on the contribution date.

Determining Availability of Suspended Losses

Property contributed to a partnership may have related losses that were not deductible by the contributing partner because of statutory limitations. The losses could have been suspended because of the application of the at-risk rules or the passive activity rules. Any losses suspended by these provisions prior to the contribution of the related property/activity remain with the contributing partner and are not transferred to the partnership.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Of the following statements, which one is accurate regarding a contribution of money or unencumbered property to a partnership?

   a. Generally, gain or loss is recognized if the contribution occurs at the time of formation of the partnership.

   b. Generally, gain or loss is recognized if the contribution occurs subsequent to the date of formation of the partnership

   c. The recipient partnership does not recognize gain or loss on the receipt of contributed property from a partner.

2. On April 1, Bob and James formed B & J Development Co. (B&J), an equal general partnership, for the purpose of developing two adjacent tracts of real estate. Bob contributed Tract 1, with a $75,000 FMV and a $50,000 basis. James contributed Tract 2, with a $75,000 FMV and a $80,000 basis. No indebtedness is associated with either tract. On October 1, after B & J's assets have increased in value to $300,000, William joins the partnership as a new partner with a one-third interest. As a result, Bob and James's interests are reduced proportionately. William contributes two tracts of land adjacent to B & J's property. William's land is not subject to liabilities and has a $150,000 FMV and a $60,000 basis. Future distributions are not anticipated that would make William's contributions subject to the disguised sale rules. Will Bob, James, or William recognize gain or loss on their contributions to B & J?

   a. Bob will recognize a gain

   b. James will recognize a loss.

   c. William will recognize a gain.

   d. All of the contributions will receive nonrecognition treatment.

3. Which of the following information would **not** meet the requirements for inclusion in the capital contribution agreement?

   a. The property's description.

   b. The property's value.

   c. The contribution date of the property.

   d. The contributing party's basis in the property.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Of the following statements, which one is accurate regarding a contribution of money or unencumbered property to a partnership? **(Page 205)**

   a. Generally, gain or loss is recognized if the contribution occurs at the time of formation of the partnership. [This answer is incorrect. As a general rule, gain or loss is *not* recognized if the contribution occurs at the time of formation of the partnership.]

   b. Generally, gain or loss is recognized if the contribution occurs subsequent to the date of formation of the partnership. [This answer is incorrect. As a general rule, *no* gain or loss is recognized on a contribution of money or unencumbered property to a partnership if the contribution occurs at a date after the date the partnership was formed.]

   c. The recipient partnership does not recognize gain or loss on the receipt of contributed property from a partner. [This answer is correct. When a partner contributes property, the recipient partnership recognizes no gain or loss on the property contributed to the partnership.]

2. On April 1, Bob and James formed B & J Development Co. (B & J), an equal general partnership, for the purpose of developing two adjacent tracts of real estate. Bob contributed Tract 1, with a $75,000 FMV and a $50,000 basis. James contributed Tract 2, with a $75,000 FMV and a $80,000 basis. No indebtedness is associated with either tract. On October 1, after B & J's assets have increased in value to $300,000, William joins the partnership as a new partner with a one-third interest. As a result, Bob and James's interests are reduced proportionately. William contributes two tracts of land adjacent to B & J's property. William's land is not subject to liabilities and has a $150,000 FMV and a $60,000 basis. Further distributions are not anticipated that would make any of the contributions subject to the disguised sale rules. Will any of the three partners recognize gain or loss on their contributions to B & J? **(Page 205)**

   a. Bob will recognize a gain. [This answer is incorrect. Bob's tract is not subject to any indebtedness and the partnership assumes no liabilities related to the transaction, therefore, he does not recognize gain or loss on the contribution of his property to the partnership.]

   b. James will recognize gain. [This answer is incorrect. James does not recognize gain or loss on his contribution of property to the partnership since his tract is not subject to liabilities and the partnership assumes no liabilities related to the transaction.]

   c. William will recognize gain. [This answer is incorrect. William does not recognize gain or loss on his contribution of property to the partnership since his tract is not subject to liabilities and the partnership assumes no liabilities related to the transaction.]

   d. All of the contributions will receive nonrecognition treatment. [This answer is correct. None of the partners will recognize a gain or loss on the contributions because the property is not subject to liabilities and the partnership assumes no liabilities in connection with the transaction.]

3. Which of the following information would **not** meet the requirements for inclusion in the capital contribution agreement? **(Page 206)**

   a. The property's description. [This answer is incorrect. The capital contribution agreement should include a description of the property or services to be contributed.]

   b. The property's value. [This answer is incorrect. The value of the property being contributed as well as the method used to determine the value should be included in the capital contribution agreement.]

   c. The contribution date of the property. [This answer is incorrect. The capital contribution agreement should include information regarding the date that the contribution is deemed to be made.]

   d. The contributing party's basis in the property. [This answer is correct. The new partner's basis in the property contributed is not included in the contribution agreement. The partnership will establish its own basis for the contributed property it holds.]

WORKING AROUND THE EXCEPTIONS TO THE NONRECOGNITION RULE

The general nonrecognition rule for property contributions to a partnership is subject to several exceptions. It does not apply if the contribution does not consist solely of property or is made to an investment company partnership. In addition, it may not apply when the contributed property is subject to liabilities, or the partnership otherwise assumes partner liabilities in connection with the transaction. The nonrecognition rule does not apply to disguised sales either. These exceptions are discussed in the following paragraphs.

IRC Sec. 721(c) provides the Treasury with regulatory authority to prevent the nonrecognition rules under IRC Sec. 721 from applying to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includable in the gross income of a person other than a U.S. person.

Handling Nonproperty Contributions

The nonrecognition rule applies only to contributions of property. While there usually is little difficulty in determining whether or not a contribution consists of property, questions can arise when a contribution could be characterized as either (a) property created by a person's services, or (b) services that create property for the partnership's benefit. This issue also arises if a partner's capital account is credited with an amount that clearly exceeds the FMV of the contributed property. In these situations, the adverse consequences of a misstep can be significant.

What Constitutes Property. In most instances, determining whether a partner's contribution is property is a simple task. Money, fee title to real estate, and ownership of equipment clearly constitute property. When the property was created by the personal efforts of a partner, however, there may be a question of whether the interest was received for the product (property) or the effort (services).

There is no requirement that the contributed property be tangible. Contract rights, goodwill, technical knowledge, and trade secrets all constitute property eligible for nonrecognition treatment. Also, a federal appeals court held that a letter of intent may constitute property. The appeals court overturned a district court ruling that a letter of intent constituted property only if it had both value and legal effect. The appeals court held that the letter of intent had value in a manner similar to goodwill. For that reason, although it was not binding, it constituted property. The property had been created by the partner's efforts, for his own account, and the partner owned the property prior to the time he contributed it to the partnership. As a result, the contribution of the letter of intent was a nonrecognition transaction.

Example 1-4: Ensuring that a partner's contribution consists of property.

Andy, a real estate developer, wished to construct an office building on Block R. To this end, Andy negotiated a letter of intent by which an investor agreed in principle (1) to provide a first mortgage loan for the project and (2) to enter into a long-term lease for the completed building. The letter of intent was not legally binding on either party.

After the letter of intent was executed, Andy decided to develop the project in a partnership with Barney and Floyd. Pursuant to a partnership agreement drafted without the help of a tax practitioner, Andy contributed the letter of intent he had negotiated. Barney, an architect, agreed to design the building and prepare architectural drawings for the partnership. Floyd contributed $75,000 cash. Each partner received an initial capital account equal to the agreed-upon FMV of the partner's contribution and a one-third interest in partnership profits and losses. Have Andy and Barney contributed property eligible for nonrecognition treatment?

Floyd's cash contribution is a property contribution. Andy's contribution of the letter of intent should be treated as a contribution of property subject to nonrecognition treatment.

Barney's services in designing the building are performed for the partnership's account. Although his services create property, namely architectural drawings, Barney agreed from the start to create this property for the partnership. He never owned the property he created. As a result, Barney's contribution does not qualify for nonrecognition treatment, and he is taxed on the receipt of his partnership interest. The FMV of that interest is treated as compensation for services. If Barney had created the designs and drawings before a partnership

had been formed (either formally or informally), so that Barney owned them with no obligation to contribute them to a partnership, a contribution of this service-created property would qualify for nonrecognition treatment.

Importance of Valuation

Even if a contribution clearly involves a property transfer, a practitioner's help may be valuable in determining the value of the contribution. In such cases, issues of value may be significant. If a contributing partner is credited with a capital account that exceeds the true value of the contributed property, the IRS might argue that the partner's interest was received only partly in exchange for property and that the excess value could be accounted for only by assuming that the partner contributed something in addition to property—for example, services. In such circumstances, only the portion of the total contribution consisting of property is entitled to nonrecognition treatment. The practitioner can help clients avoid this problem by ensuring that capital accounts reflect only the value of property contributed by the partners.

Dealing with the Investment Company Partnership Rules

The nonrecognition rule for partnership contributions cannot be used to avoid gain recognition when the assets contributed to an investment company consist largely of stock and securities, as defined in IRC Sec. 351(e)(1)(B).

What Is Considered Stocks and Securities? IRC Sec. 351(e)(1)(B) lists the following classes of property that are included in the definition of stocks and securities for investment company purposes:

a. Money.

b. Stock and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

c. Any foreign currency.

d. Any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly traded partnership, or any other equity interest (other than in a corporation) that pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any of the other items included in this list.

e. Except to the extent provided in regulations, any interest in a precious metal, unless it is used or held in the active conduct of a trade or business after the contribution.

f. Except as otherwise provided in regulations, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any other item included in this list. According to the Senate Report (PL 105-33, Sec. 1002), until regulations are issued, the definition of *substantially all* in IRC Sec. 731(c)(2) should be applied. An entity will meet the substantially all requirement if 90% or more of its assets are listed assets.

g. To the extent provided in regulations, any interest in any entity not described in item f., but only to the extent of the value of such interest that is attributable to other assets included in this list. According to the Senate Report (PL 105-33, Sec. 1002), until regulations are issued, Reg. 1.731-2(c)(3)(ii) should be followed. According to that regulation, where 20% or more, but less than 90%, of the entity's assets consist of listed assets, a prorata portion of the interest in the entity will be treated as a listed asset.

h. Any other asset specified in regulations.

Great care must be taken when contributing money, since it is considered to be a stock or security under IRC Sec. 351(e)(1)(B). Documentation should be made for the use of any cash contributed that is part of a plan to achieve diversification and that is not intended to be used to purchase assets defined as stock and securities.

Tests to Be Considered an Investment Company. A partnership is an investment company for these purposes if it meets two tests:

a. After the capital contribution in question has been made, more than 80% of the value of the partnership's assets are held for investment and consist of stocks and securities (or interests in regulated investment companies or real estate investment trusts).

b. The contribution results in a direct or indirect diversification of the contributor's interest. This normally is deemed to occur if there is more than a nominal difference in contributed assets.

Meaningful Diversification. There must be meaningful diversification for the investment company rule to come into play. In Ltr. Rul. 9608026 a limited partnership among related parties was formed. One partner contributed publicly traded securities with significant value, while the others contributed cash worth less than 1% of the total value of the contributions. The partner contributing the securities did not diversify his portfolio because he was the only significant contributor. Since diversification cannot be achieved without at least two significant contributors, IRC Sec. 721(b) did not apply. In addition, diversification must result from partner contributions rather than from later partnership transactions.

If all contributing partners contribute diversified portfolios of stocks and securities, IRC Sec. 721(b) does not apply. This is because diversification is already present before the contributions. Accordingly, the act of contributing a diversified portfolio of investment assets to a partnership does not result in diversification for the contributing partners. For purposes of this test, government securities are included in the total value of contributed assets, but are not treated as securities of an issuer. In Ltr. Rul. 200317011, when a husband and wife exchanged interests in individually and jointly owned property and then contributed those interests to a new partnership, the contribution was not subject to the investment company rules. The IRS found that the husband and wife were co-owners of each of the contributed assets, so no diversification occurred.

Diversification is satisfied if the 25% and 50% tests of IRC Sec. 368(a)(2)(F)(ii) are met. These tests indicate that if no more than 25% of the value of the total assets contributed by the transferor is invested in stock and securities of any one issuer, and no more than 50% of the value of the total assets contributed by the transferor is invested in the stock and securities of five or fewer issuers, the portfolio is considered diversified.

As mentioned earlier, cash is included within the definition of stock and securities for investment company purposes. Reg. 1.351-1(c)(6) does not address whether cash is considered a diversified asset. Therefore, a question existed as to whether a contribution of cash along with a diversified stock portfolio would be treated as diversifying the contributing partner's holdings. If a cash contribution were treated as diversifying the contributors' holdings it would cause the new partnership to be treated as an investment company and result in the contributing partners recognizing gain on the contribution. In Ltr. Rul. 200008025, the IRS ruled that a contributing partner would not recognize any gain on its contribution of cash and a diversified portfolio of stock and securities in exchange for an interest in a newly formed partnership.

If a partner's contribution of assets serves to diversify the investment interests of the partnership, the contributing partner is required to recognize gain as if he had sold the property to the partnership. This rule applies only if the sale of the property to the partnership would generate a gain—losses cannot be recognized. The gain recognition rule applies to contributions to existing partnerships as well as to contributions made upon formation.

Example 1-5: Gain recognized on contribution to investment company.

Jane Clifton owns common stock in the SODA Company (traded on the NYSE). The FMV of the stock is $50,000, and Jane's tax basis in the stock is $10,000. Roger Valley owns preferred stock and convertible debentures in the OIL Company (traded on the NASDAQ). He paid $25,000 for the convertible debentures and $10,000 for the preferred stock. The stock and debentures have a combined FMV of $50,000. In an effort to diversify their investment risks associated with these stock holdings, Jane and Roger each contribute their securities to S&O Partnership.

Because S&O is an investment company, Jane must recognize gain of $40,000 on her contribution and Roger must recognize gain of $15,000. Jane's initial basis in her partnership interest is $50,000, as is Roger's (IRC

Sec. 722). S&O's basis in the securities is equal to their FMV on the contribution date, and holding period for S&O begins on that date (IRC Sec. 723).

If Jane's basis in her stock had been $60,000, she would not have recognized a loss on the contribution. Instead, S&O would have had a basis of $60,000 in the shares and a sale of the shares for their $50,000 FMV would have resulted in a $(10,000) loss to the partnership. [This loss would have been allocated 100% to Jane.]

Example 1-6: Avoiding gain recognition under the investment company rules.

To pool investment assets, Dean, Merrill, and E.F. have agreed to form a general partnership, Stocks 'R' Us. Each partner will have a one-third interest and will contribute stock with a $20,000 FMV. Dean will contribute Ibis Corp. stock, in which his basis is $7,000, and Merrill will contribute India Black, Inc., stock with a $25,000 basis. E.F. has agreed to contribute Wintwins Co. stock, in which her basis is $22,000. Before making their capital contributions, the partners have asked a tax practitioner for advice regarding any potential tax problems associated with their proposal.

The assets of Stocks 'R' Us satisfy the first investment company requirement after the planned contributions. A diversification of interests also occurs, since each partner, instead of owning 100% of one stock, has a one-third interest in three stocks. Consequently, if Stocks 'R' Us is formed as contemplated, Dean recognizes a $13,000 gain on his contribution. Dean would receive a step-up in the basis of his partnership interest for the gain recognized (IRC Sec. 722). The contribution remains a nonrecognition transaction for the other partners because Merrill and E.F. realize losses, and the investment company rule applies only to gains.

If Dean later increased his interest in Stocks 'R' Us to 50% by contributing additional Ibis Corp. stock with the same basis and FMV as his initial contribution, he would recognize an additional $13,000 gain.

The most practical alternative would be to have Dean contribute securities that would not produce a gain. Dean could also avoid gain recognition if (1) each partner contributed portfolios with only nominal differences in assets, so that no diversification would occur, or (2) additional assets were contributed so that (after taking all contributions together) the value of the securities would constitute less than 80% of the value of the total assets.

Variation 1: Assume Dean, Merrill, and E.F. each contribute a portfolio of stocks to the partnership. Each portfolio consists of stocks from 20 different companies. Each block of stock has a FMV of $1,000. Thus, the total FMV of each partner is $20,000. Each partner's adjusted basis in the stocks is the same as before.

The contribution meets the 80% test under the investment company rule. However, a transfer of stocks and securities will not result in diversification if each partner transfers a diversified portfolio. If all contributing partners contribute diversified portfolios of stocks and securities, IRC Sec. 721(b) does not apply. Since each partner meets the 25% and 50% tests, the contributions are already diversified and the investment company rules do not apply.

Variation 2: Assume the same facts as in the original example, but Dean contributed $20,000 cash that will be used to purchase additional stock and securities by the partnership. Based on IRC Sec. 351(e)(1)(B), cash is considered stock and securities for investment company purposes. Therefore, the contributions will meet the 80% test and result in diversification. However, none of the contributed assets is appreciated. Thus, even though the partnership is an investment company, no gain is recognized by the partners at this time.

Although the investment company rules of IRC Sec. 721(b) are currently applied only to partnerships and LLCs owning marketable stock and securities, the IRS has indicated that this provision may be more widely applied in the future. In Rev. Proc. 2010-3, the IRS indicated that it would not issue a ruling on whether IRC Sec. 721 applies to the contribution of widely held developed or undeveloped real property or interests therein; widely held oil and gas properties or interests therein; or any similarly held properties or interests to a partnership in exchange for an interest in the partnership when (a) the contribution is the result of solicitation by promoters, brokers, or investment houses, or (b) the interest in the transferee partnership is issued in a form designed to render it readily tradable.

Contributing Assets Subject to Liabilities

Contributions of encumbered property are taxable in certain situations when the liabilities transferred exceed the contributor's basis in the contributed property. The partnership rules governing such contributions can be illustrated by comparing them with the rules that apply to shareholder contributions of property to a corporation. If property is contributed to a corporation in exchange for stock and the corporation assumes liabilities (or accepts the property subject to liabilities) in an amount that exceeds the contributor's adjusted basis in the contributed property, the contributor generally recognizes gain to the extent of the excess liabilities even though the contribution otherwise meets the requirements for nonrecognition treatment.

The partnership rules are similar to the corporate rules, but they differ in one important respect. Any increase in a partner's share of liabilities is treated as a contribution of money and any decrease in a partner's share of liabilities is treated as a distribution of money. These constructive contributions and distributions are deemed to take place to reflect the changed interests of the contributing partner and the other partners in the assumed liability and other partnership liabilities. Gain is recognized only if the amount of the contributor's deemed cash distribution caused by the assumption of transferred liabilities by other partners exceeds the sum of (a) the basis of the contributed property, (b) any deemed cash contribution from the contributor's assumption of partnership liabilities, and (c) the contributor's preexisting basis in the partnership interest, if any. Because gain recognition is not automatic, the practitioner can take advantage of planning opportunities to help clients avoid gain recognition problems on contributions of encumbered property.

In three identical technical advice memorandums, the IRS ruled contributions to and distributions from a partnership would be netted to determine whether there was a net contribution by the partners to the partnership or a net distribution by the partnership to the partners. In this particular situation, the transactions were related and the contribution would not have taken place without the distributions. Because a new partner's admission generally changes profit and loss sharing ratios, partners are usually affected by these rules whenever such an admission occurs.

Under Reg. 1.752-1(e), when a partner contributes property to a partnership that is subject to a liability, the partnership is considered to have assumed the liability only to the extent the amount of the liability does not exceed the property's FMV on the contribution date. This situation is most likely to arise in the case of real estate subject to a mortgage or deed of trust, but could arise in other situations as well. If a partnership receives a contribution of property subject to a liability, two constructive transactions are deemed to occur simultaneously (Rev. Rul. 87-120). First, each partner is treated as having made a contribution of money to the partnership in an amount equal to that partner's share of any liabilities assumed by the partnership. Second, the contributing partner is deemed to have received a distribution of money equal to the entire amount of the liability assumed by the partnership with respect to the contributed property. Gain is recognized by the contributing partner only if the deemed distribution from the transfer of liabilities to the partnership exceeds his basis in the partnership interest immediately after the contribution. His basis in the partnership interest is computed by adding (a) his preexisting basis in the partnership interest, (b) his basis in the contributed property, and (c) his deemed contribution. Gain is recognized only if the amount of the transferred liability—the contributor's deemed distribution—exceeds this sum.

In addition to scrutinizing contributions made upon the formation of a partnership, careful review of contributions made to ongoing partnerships by new or existing partners must be made. The issues previously discussed must all be considered each time a contribution is made to the partnership. In addition, such contributions may be accompanied by changes in profit and loss sharing ratios. Such changes result in shifts in liability sharing, which again produces constructive contributions and distributions that can affect the taxation of the transaction. If the partner's share of partnership liabilities decreases as a result of the transaction, the probability that he or she will recognize gain increases. In these situations, it is possible that even noncontributing partners could recognize gain if their shares of liabilities decrease. (See Example 1-10.)

Example 1-7: Tax impact of recourse mortgage on noncontributing partners.

Dobie and Maynard plan to form D&M Enterprises (D&M), a general partnership, to renovate and operate a small shopping mall in a building owned by Maynard. The parties agree that Dobie will contribute $50,000 cash for a 50% interest. For the other 50% interest, Maynard intends to contribute the building, which has a $180,000 FMV and is subject to a fully recourse mortgage of $130,000 incurred to acquire the property.

Maynard's depreciated basis in the property is $60,000. Will Maynard's contribution of property subject to a liability exceeding the basis of the property qualify for nonrecognition treatment?

If Maynard contributes the building to D&M, Dobie and Maynard each are deemed to have made cash contributions to the partnership of $65,000—half of the $130,000 liability to which the contributed property was subject. In addition, Maynard is deemed to have received a cash distribution from D&M in the amount of the liability—$130,000. The shift of liabilities has no immediate tax consequences to Dobie, other than increasing his basis in his partnership interest from $50,000 to $115,000. The consequences to Dobie are as follows:

Dobie's deemed distribution attributable to the transfer of liabilities to the partnership	$ —
Dobie's preexisting basis	—
Basis acquired from contributions of cash and property	(50,000)
Basis from deemed contributions attributable to share of new partnership liabilities	(65,000)
Total gain or (new basis)	$ (115,000)

The calculation effectively nets the increase and decrease in Dobie's liabilities as part of the gain calculation.

Example 1-8: Tax impact of recourse mortgage on contributing partner.

For Maynard, in the preceding example, the effects of the contribution are more complex. Because he has no basis in his partnership interest prior to the contribution, Maynard acquires a $60,000 basis in D&M—his basis in the contributed property. He is then deemed to make a $65,000 cash contribution equal to his 50% of the partnership's debt. At the same time, Maynard is treated as having received a $130,000 distribution from the partnership. The result of the simultaneous deemed contribution and distribution is a net deemed distribution of $65,000. This net distribution reduces Maynard's $60,000 basis, but cannot reduce that basis below zero (IRC Sec. 733). Because the net deemed cash distribution exceeds his basis in the partnership interest, Maynard recognizes the excess ($5,000) as gain from the deemed sale or exchange of his partnership interest (IRC Sec. 731). The character of that gain is determined as if there had been an actual cash distribution. Afterwards, he has a zero basis in his partnership interest as illustrated by the following:

Maynard's deemed distribution attributable to the transfer of liabilities to the partnership	$ 130,000
Maynard's preexisting basis	—
Basis acquired from contributions of cash and property	(60,000)
Basis from deemed contributions attributable to share of new partnership liabilities	(65,000)
Gain recognized on contribution	$ 5,000

If the liability had been $110,000 rather than $130,000, the liability would still exceed Maynard's basis in the building, but no gain would be recognized because the net constructive distribution to Maynard would be $55,000 ($110,000 deemed distribution less $55,000 deemed contribution), which is less than Maynard's $60,000 partnership basis immediately prior to accounting for the constructive contributions and distributions. The excess $5,000 is Maynard's basis in his partnership interest after the contribution.

The partners in the preceding two examples might consider structuring their transaction differently to help Maynard avoid recognizing gain. Some alternatives are increasing Maynard's basis in his partnership interest or reducing the liability involved. For example, prior to the contribution, D&M could borrow an amount sufficient to increase Maynard's share of partnership liabilities by at least $5,000. This would also increase Maynard's basis by the same amount and prevent recognizing gain on his contribution. If borrowings are expected in the near future anyway, accelerating the borrowings is a relatively painless way to avoid Maynard's gain recognition (the only cost is additional interest expense). However, the IRS might challenge a partnership borrowing that had no purpose other than to allow Maynard to avoid gain recognition on his contribution.

Maynard might also reduce the mortgage liability prior to contributing the property. This could be done by paying off a portion of the liability, converting the liability to an unsecured debt that will not be assumed by the partnership, or substituting some of Maynard's personal property that will not be contributed to the partnership as security for the liability. In a similar vein, Maynard could increase his basis by making precontribution improvements to the property, or contributing cash in addition to the property. However, these actions alter the net value of Maynard's contribution, which the partners must take into account in structuring the economics of their business arrangement.

Contributing Assets Subject to Nonrecourse Liabilities

If property contributed to a partnership is subject to only nonrecourse liabilities, the likelihood of the contributing partner recognizing gain is minimized. A partner's share of partnership nonrecourse liabilities equals the sum of:

a. the partner's share of partnership minimum gain, plus

b. the partner's share of Section 704(c) minimum gain, plus

c. the partner's share of excess nonrecourse liabilities.

Since the second tier of allocation is Section 704(c) minimum gain, the contributing partner is generally allocated an amount of partnership nonrecourse liabilities equal to the difference between the FMV and basis of the contributed property on the contribution date.

Example 1-9: Recognizing gain on the contribution of assets subject to nonrecourse debt.

Assume the same facts as in Example 1-7, except the contributed debt is nonrecourse. The computation of Maynard's gain would be as follows.

Maynard's share of debt after contribution:	
Section 704(c) minimum gain ($130,000 − $60,000)	$ 70,000
50% of "excess" liabilities [50% × ($130,000 − $70,000)]	30,000
Total	$ 100,000
Maynard's deemed distribution attributable to the transfer of liabilities to the partnership	$ 130,000
Maynard's preexisting basis	—
Basis acquired from contributions of cash and property	(60,000)
Basis from deemed contributions attributable to share of new partnership liabilities (see preceding calculation)	(100,000)
Total gain (or new basis)	$ (30,000)

The nonrecourse debt allocation rules prevent Maynard from recognizing gain if the contributed property is encumbered by nonrecourse debt. His basis in the partnership interest is $30,000.

The shift in partnership liabilities may be a problem when a partnership interest is converted from a general partner interest to a limited partner interest. Since a general partner is allocated basis for his or her share of recourse debt and a limited partner is generally not allocated any basis from such debt, a shift from general partner status to limited partner status may result in a deemed distribution to the converting partner. Even though that partner's sharing ratio in partnership profits and losses remains the same, the conversion may result in taxable income to the partner if the deemed distribution resulting from the decreased interest in partnership recourse liabilities is greater than the basis in the partnership interest before the conversion. Similar to Example 1-9, if the note is nonrecourse, the results would be different.

Example 1-10: Avoiding recognition of gain when a property contribution causes a shift in partnership liabilities.

Bob Blueford and Paul Oldman form Gold Screen Partners, a general partnership, to build and operate a six-screen movie theater. They decide to build a new eight-screen theater in a neighboring town a few years

later. Because their business is not generating a lot of cash, Bob and Paul are admitting Clint Westwood into the partnership to help finance the new theater. Clint will be admitted as a 70% partner in exchange for a $1,260,000 contribution. At the time of Clint's admission, the balance sheet of Gold Screen Partners is as follows (the partnership is on the accrual basis):

	Basis	FMV
Cash	$ 15,000	$ 15,000
Depreciable property	465,000	1,275,000
Land	150,000	250,000
Total assets	$ 630,000	$ 1,540,000
Notes payable (recourse)	$ 1,000,000	$ 1,000,000
Capital		
Bob	(185,000)	270,000
Paul	(185,000)	270,000
Total liabilities & capital	$ 630,000	$ 1,540,000

A problem exists because of the deemed distributions that occur with the shift in partnership liabilities upon admitting Clint. Clint's assumption of partnership liabilities constitutes a deemed contribution to the partnership, and the reductions in Bob's and Paul's shares of partnership liabilities constitute deemed distributions to them. (Note that a different result is reached if the debt is nonrecourse, see Example 1-9.) Bob and Paul will have a tax problem due to the deemed distribution resulting from Clint's assumption of partnership liabilities.

After admitting Clint, the partnership's balance sheet is as follows:

	Basis	FMV
Cash	$ 1,275,000	$ 1,275,000
Depreciable property	465,000	1,275,000
Land	150,000	250,000
Total assets	$ 1,890,000	$ 2,800,000
Notes payable (recourse)	$ 1,000,000	$ 1,000,000
Capital		
Bob	(185,000)	270,000
Paul	(185,000)	270,000
Clint	1,260,000	1,260,000
Total liabilities & capital	$ 1,890,000	$ 2,800,000

Clint is deemed to have contributed $1,260,000 cash plus $700,000 representing his 70% share of partnership liabilities. Bob and Paul are deemed to have received a cash distribution of $350,000 each (half of the $700,000 deemed contributed by Clint). Since Bob and Paul each have only a $315,000 basis in their partnership interests [their ($185,000) negative capital account plus their $500,000 share of partnership liabilities] before Clint's contribution, they each are deemed to receive a $35,000 cash distribution in excess of their basis, generating a taxable gain equal to that amount.

When determining the tax effects of admitting a new partner to an ongoing partnership, the tax practitioner must look not only at the actual contributions, but also at the deemed contributions and distributions due to the change in the partners' sharing of partnership liabilities. To avoid the gain recognition by Bob and Paul upon Clint's admission, the tax practitioner might suggest one of several alternatives.

If Gold Screen Partners were converted to a limited partnership, and Clint were admitted as a limited partner, he would not be liable for any of the $1 million of recourse debt. Since Bob and Paul each would still be liable for 50% of the $1 million recourse note, they would not recognize any gain or loss on Clint's admission. Alternatively, Bob,

Paul, and Clint could form a new partnership to build the theater. If a new partnership were formed, Clint would obviously not be assuming any of the $1 million note, and Bob and Paul would not recognize any gain. Although both of these alternatives would avoid the recognition of gain by Bob and Paul, each would change the business deal among the partners and might require the partners to renegotiate the terms of their deal.

Applying the Special Rules on Abusive Liability Assumptions

In May 2005, Treasury issued final and temporary regulations addressing abusive transactions involving the contribution of liabilities to a partnership and subsequent disposition of the partnership interest. These transactions accelerate or duplicate losses through the assumption of (or transfer of assets subject to) liabilities. An example of such an arrangement involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that debt. For example, a taxpayer may receive $5,000 cash from a lender under a loan agreement that provides a stated principal amount of $4,000 and an inflated rate of interest. The taxpayer contributes the $5,000 to a partnership, and the partnership assumes the $4,000 debt. At a later time, the taxpayer sells his partnership interest. The taxpayer claims that only the $4,000 principal amount of the debt is assumed by the partnership, resulting in the taxpayer having a basis in his partnership interest of $1,000—the $5,000 cash contributed, less the $4,000 deemed distribution of cash from the assumption of the taxpayer's debt by the partnership. Upon disposition, the taxpayer claims a loss of $1,000, even though he has incurred no corresponding economic loss. In another variation of this transaction, taxpayers use put and call options to achieve substantially the same result.

A Reg. 1.752-7 liability is defined as any fixed or contingent liability that is not described in Reg. 1.752-1(a)(4)(ii), to the extent that either the obligation is not described in that regulation, or the amount of the obligation exceeds the amount taken into account under Reg. 1.752-1(a)(4)(i). Reg. 1.752-1(a)(4)(ii) defines an obligation as any fixed or contingent obligation to make payment regardless of whether the obligation is otherwise taken into account under the Internal Revenue Code. Obligations include debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. Reg. 1.752-1(a)(4)(i) provides that an obligation is a liability for the purposes of IRC Sec. 752 only if and to the extent the obligation—

a. creates or increases the basis of any of the obligor's assets (including cash);

b. gives rise to an immediate deduction to the obligor; or

c. gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital (such as a penalty, or the nondeductible portion of meals and entertainment expenses).

The amount of a Reg. 1.752-7 liability or obligation is the amount of cash a willing assignor would pay a willing assignee to assume the liability or obligation in an arm's-length transaction. If the obligation arose under a contract in exchange for rights granted to the obligor under that contract, and those rights are contributed to a partnership in connection with its assumption of the contractual obligation, the amount of the liability or obligation is the amount of cash a willing assignor would pay a willing assignee to assume the whole contract. A partner's share of a partnership's Reg. 1.752-7 liability is the amount of the deduction that would be allocated to the partner if the partnership disposed of all of its assets, satisfied all its liabilities other than Reg. 1.752-7 liabilities, and paid an unrelated person to assume all of its Reg. 1.752-7 liabilities in a fully taxable arm's-length transaction (assuming such payment would give rise to an immediate deduction).

Example 1-11: Valuing Reg. 1.752-7 liabilities.

Wally, Eddie, and Beaver form Pleasantville Partnership. Beaver contributes $100,000 in exchange for a 25% interest in the partnership plus the partnership's assumption of an obligation with an issue price and a stated redemption price of $50,000. The obligation was issued for cash and bears interest at a fixed rate of interest (payable quarterly) that was a market rate when the obligation was issued. At the time the partnership assumed the obligation, all interest payments were current. Prior to the assumption of the obligation by the partnership, interest rates decrease, resulting in the obligation carrying an above-market rate of interest. Assume that, as a result of the decline in interest rates, Wally would have had to pay a willing assignee $60,000 to assume the debt obligation. The assumption of the obligation by the partnership is treated as the

assumption of a $50,000 regular Section 752 liability (the portion that created basis) and a $10,000 Reg. 1.752-7 liability. This example illustrates that the nature of a contributed liability may be bifurcated.

Contribution of Reg. 1.752-7 Liabilities. Regulations address how Reg. 1.752-7 liabilities are treated when they are assumed by a partnership as part of a tax-free contribution by a partner, when a partner other than the contributing partner assumes part or all of the liability from the partnership, and when the contributing partner subsequently sells or exchanges all or part of his partnership interest or receives a distribution in liquidation of his partnership interest. The regulations prevent the duplication of loss by prohibiting the partnership and any person other than the contributing partner from claiming a deduction or capital expense to the extent of the built-in loss associated with the obligation. The regulations also prevent the acceleration of loss by deferring the contributing partner's deduction or loss attributable to the obligation until the obligation is satisfied.

It is important to note that under certain exceptions the subsequent transfer of the contributor's partnership interest, the liquidation of the contributor's partnership interest, or the assumption of the transferred liability by another partner does not trigger the application of the Reg. 1.752-7 rules. The first exception applies if a partnership assumes a Reg. 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business. If a partnership (upper-tier entity) assumes a Reg. 1.752-7 liability of a partner, and, subsequently, another partnership (lower-tier entity) assumes that Reg. 1.752-7 liability from the upper-tier entity, then the Reg. 1.752-7 liability is treated as associated only with any trade or business contributed to the upper-tier entity by the contributing partner.

The second exception applies if immediately before the testing date, the remaining built-in loss on all Reg. 1.752-7 liabilities assumed by the partnership (except those assumed in connection with an associated trade or business) in one or more Reg. 1.752-7 liability transfers, is less than (a) the lesser of 10% of the partnership's gross value or (b) $1 million. The testing date is the date of a sale, exchange, or other disposition of part or all of the Reg. 1.752-7 liability partner's interest; the date of the partnership's distribution in liquidation of the Reg. 1.752-7 liability partner's interest; or the date of the assumption (or partial assumption) of the Reg. 1.752-7 liability by a partner other than the Reg. 1.752-7 liability partner.

When a partnership assumes a partner's liability in connection with a contribution of property to the partnership, the liability assumed is treated as having a built-in loss under the rules of IRC Sec. 704(c). The amount of the built-in loss is the amount of the Reg. 1.752-7 liability on the date it is assumed by the partnership. Consequently, items of deduction or loss with respect to the liability must be allocated first to the contributing partner to the extent of the built-in loss. Remaining deductions or losses are allocated among the other partners based on the Section 704(b) allocation rules.

A decrease or increase in the value of a Reg. 1.752-7 liability after it is contributed to the partnership is an item of income or loss if it is reflected in the partners' capital accounts. This income or loss is allocated among the partners based on the general rules for allocating income and loss outlined in IRC Sec. 704(b).

Tiered Ownership Structures. The final and temporary regulations provide that a contribution by a partner of an interest in a partnership (lower-tier entity) to another partnership (upper-tier entity) is treated as a contribution of the partner's share of each of the lower-tier entity's assets and an assumption by the upper-tier entity of the partner's share of the lower-tier entity's liabilities.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. The general nonrecognition rule for property contributions applies to which of the following?

   a. Contribution of at least 51% property.

   b. Contribution to an investment company partnership.

   c. Contribution of fee title to real estate.

   d. Disguised sales.

5. Jim, who develops real estate, wanted to construct an office building on a lot in his neighborhood. Subsequently, Jim negotiated a non-binding letter of intent wherein an investor basically agreed to provide a first mortgage loan for the construction project, and to enter into a long-term lease for the building once completed. Subsequently, Jim decided to develop the project in a partnership with Adam and David. In accordance with a partnership agreement drafted without assistance from a tax specialist, Jim contributed the letter of intent he had previously negotiated. Adam, who is an architect, agreed to design the building and prepare architectural drawings for the partnership. David made a cash contribution of $125,000. Each partner received an initial capital account equal to the agreed-upon FMV of the partner's contribution plus a one-third interest in partnership profits and losses. Of the three partners, which one's contribution does not qualify as a property contribution and, therefore, is unqualified for nonrecognition treatment?

   a. Jim.

   b. Adam.

   c. David.

6. An entity meets the *substantially all* requirement defined in IRC Sec. 731(c)(2) if ______ of its assets are listed assets.

   a. 50% or more.

   b. 67% or more.

   c. 80% or more.

   d. 90% or more.

7. The investment company rule would apply to a partnership under which of the following scenarios?

   a. A partnership with limited diversification

   b. A partnership where one partner contributed publicly traded securities with high value, and the other partners contributed cash worth less than 8% of the total value of the contributions.

   c. A partnership where three partners contributed publicly traded securities with significant value, and the remaining partners contributed a minimal amount of cash by comparison to the total contributions.

   d. A partnership where all of the contributing partners contributed diversified portfolios of stocks and securities.

8. Bill owns common stock in Pyramid Plastics Company (traded on the NYSE). The FMV of the stock is $100,000, and Bill's tax basis in the stock is $20,000. Randy owns preferred stock and convertible debentures in Southwestern Petroleum Company (traded on the NASDAQ). He paid $50,000 for the convertible debentures and $25,000 for the preferred stock. The stock and debentures have a combined FMV of $85,000. In an attempt to diversify their investment risks associated with these stock holdings, Bill and Randy each contribute their securities to J&J Partnership. As a result of these actions, Randy must recognize gain of ________ on his contribution.

   a. $85,000.

   b. $75,000.

   c. $50,000.

   d. $10,000.

9. When contributing assets that are subject to liabilities, which of the following statements applies to property contributions to a corporation?

   a. Gain is recognized to the extent of the excess liabilities when property is contributed in exchange for stock and the property is accepted subject to a specified liability amount.

   b. Any increase in a share of liabilities is treated as a contribution of money.

   c. Any decrease in a share of liabilities is treated as a distribution of money.

10. Robert and David intend to form R&D Enterprises (R&D), a general partnership, to remodel and operate a small strip shopping center in a building owned by David. The parties agree that Robert will contribute $70,000 cash for a 50% interest. For the other 50% interest, David plans to contribute the building, which has a $175,000 FMV and is subject to a fully recourse mortgage of $105,000 incurred to acquire the property. David's depreciated basis in the property is $60,000. David ultimately contributes the building to R&D. David is deemed to have received a cash distribution from R&D in the amount of:

    a. $52,500.

    b. $60,000.

    c. $105,000.

    d. $122,500.

11. Assume the same information in the self-study question above, except the contributed debt is nonrecourse. David's total gain is:

    a. $105,000.

    b. $75,000.

    c. $30,000.

    d. $45,000.

12. An obligation would **not** be a liability for the purposes of IRC Sec. 752 in which of the following instances?

    a. It increases the basis of the obligor's cash.

    b. It provides for a prompt deduction to the obligor

    c. It gives rise to a penalty.

    d. It provides for a non arm's-length transaction.

13. Which of the following statements regarding a partner/partnership liability or obligation is accurate?

    a. When a partner's liability is assumed by the partnership in connection with a contribution of property to the partnership, the liability that has been assumed is treated as having a built-in loss under the rules of IRC Sec. 704(c), Reg. 1.752-7(j)(2).

    b. The amount of the built-in loss in (a) above is the amount of the Reg. 1.752-7 liability within 10 days of the date the partnership assumes such loss.

    c. Items of deduction or loss regarding the liability must first be allocated to the partnership to the degree of the built-in loss.

    d. After items of deduction or loss related to the liability have been allocated, remaining deductions or losses are allocated among the other partners.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. The general nonrecognition rule for property contributions applies to which of the following? **(Page 213)**

   a. Contribution of at least 51% property. [This answer is incorrect. The general nonrecognition rule for property contributions only applies if the contribution consists entirely of property.]

   b. Contribution to an investment company partnership. [This answer is incorrect. The property contribution nonrecognition rule does not apply if the contribution is made to an investment company partnership.]

   c. Contribution of fee title to real estate. [This answer is correct. The nonrecognition rule applies to property contributions and can consist of fee title to real estate, money, ownership of equipment, and other things clearly classified as property.]

   d. Disguised sales. [This answer is incorrect. Disguised sales do not qualify for application of the general nonrecognition rule for property contributions to a partnership.]

5. Jim, who develops real estate, wanted to construct an office building on a lot in his neighborhood. Subsequently, Jim negotiated a non-binding letter of intent wherein an investor basically agreed to provide a first mortgage loan for the construction project, and to enter into a long-term lease for the building once completed. Subsequently, Jim decided to develop the project in a partnership with Adam and David. In accordance with a partnership agreement drafted without assistance from a tax specialist, Jim contributed the letter of intent he had previously negotiated. Adam, who is an architect, agreed to design the building and prepare architectural drawings for the partnership. David made a cash contribution of $125,000. Each partner received an initial capital account equal to the agreed-upon FMV of the partner's contribution plus a one-third interest in partnership profits and losses. Of the three partners, which one's contribution does not qualify as a property contribution and, therefore, is unqualified for nonrecognition treatment? **(Page 213)**

   a. Jim. [This answer is incorrect. Jim's contribution of the letter of intent should be treated as a contribution of property and would be subject to nonrecognition treatment.]

   b. Adam. [This answer is correct. Since Adam created architectural drawings after the formation of the partnership, he never owned the property he created. Therefore, his contribution of architectural drawings does not qualify for nonrecognition treatment. Adam must pay tax on the receipt of his partnership interest.]

   c. David. [This answer is incorrect. David made a cash contribution which is a property contribution. As a result, his contribution is eligible for nonrecognition treatment.]

6. An entity meets the *substantially all* requirement defined in IRC Sec. 731(c)(2) if ______ of its assets are listed assets. **(Page 214)**

   a. 50% or more. [This answer is incorrect. If only half of an entity's assets are listed assets, it does not meet the definition of *substantially all* as defined in IRC Sec. 731(c)(2).]

   b. 67% or more. [This answer is incorrect. The *substantially all* definition is not met when only two-thirds of an entity's assets are listed assets.]

   c. 80% or more. [This answer is incorrect. If 80% of an entity's assets are listed assets, the entity does not meet the definition of *substantially all* in IRC Sec. 731(c)(2).]

   d. 90% or more. [This answer is correct. An entity meets the *substantially all* requirement in IRC Sec. 731(c)(2) if 90% or more of its assets are listed assets.]

7. The investment company rule would apply to a partnership under which of the following scenarios? **(Page 215)**

   a. A partnership with limited diversification. [This answer is incorrect. In order for the investment company rule to apply, the partnership must engage in meaningful diversification.]

   b. A partnership where one partner contributed publicly traded securities with high value, and the other partners contributed cash worth less than 8% of the total value of the contributions. [This answer is incorrect. The partner was not successful in diversifying his portfolio since he was the only significant contributor.]

   c. A partnership where three partners contributed publicly traded securities with significant value, and the remaining partners contributed a minimal amount of cash by comparison to the total contributions. [This answer is correct. Meaningful diversification can occur when there are at least two significant contributors to the partnership making application of the investment company rule possible.]

   d. A partnership where all of the contributing partners contributed diversified portfolios of stocks and securities. [This answer is incorrect. If all contributing partners contribute diversified portfolios of stocks and/or securities, the investment company rule does not apply since diversification already exists prior to the contributions.]

8. Bill owns common stock in Pyramid Plastics Company (traded on the NYSE). The FMV of the stock is $100,000, and Bill's tax basis in the stock is $20,000. Randy owns preferred stock and convertible debentures in Southwestern Petroleum Company (traded on the NASDAQ). He paid $50,000 for the convertible debentures and $25,000 for the preferred stock. The stock and debentures have a combined FMV of $85,000. In an attempt to diversify their investment risks associated with these stock holdings, Bill and Randy each contribute their securities to J&J Partnership. As a result of these actions, Randy must recognize gain of ________ on his contribution. **(Page 215)**

   a. $85,000. [This answer is incorrect. $85,000 is Randy's initial basis in his partnership interest.]

   b. $75,000. [This answer is incorrect. $75,000 is the combined total Randy paid for the convertible debentures and the preferred stock.]

   c. $50,000. [This answer is incorrect. $50,000 is the amount Randy paid for the convertible debentures.]

   d. $10,000. [This answer is correct. Since J&J is an investment company, Randy must recognize gain of $10,000 on his contribution.]

9. When contributing assets that are subject to liabilities, which of the following statements applies to property contributions to a corporation? **(Page 216)**

   a. Gain is recognized to the extent of the excess liabilities when property is contributed in exchange for stock and the property is accepted subject to a specified liability amount. [This answer is correct. When property is contributed to a corporation in exchange for stock and the corporation assumes liabilities or accepts the property subject to liabilities in an amount that is greater than the contributor's adjusted basis in the contributed property, the contributor normally recognizes gain to the extent of the excess liabilities even if the contribution otherwise meets the requirements for nonrecognition treatment.]

   b. Any increase in a share of liabilities is treated as a contribution of money. [This answer is incorrect. Any increase in a share of liabilities is treated as a contribution of money for property contributions to a *partnership*.]

   c. Any decrease in a share of liabilities is treated as a distribution of money. [This answer is incorrect. Any decrease in a share of liabilities is treated as a distribution of money for property contributions to a *partnership*.]

10. Robert and David intend to form R&D Enterprises (R&D), a general partnership, to remodel and operate a small strip shopping center in a building owned by David. The parties agree that Robert will contribute $70,000 cash for a 50% interest. For the other 50% interest, David plans to contribute the building, which has a $175,000 FMV and is subject to a fully recourse mortgage of $105,000 incurred to acquire the property. David's depreciated basis in the property is $60,000. David ultimately contributes the building to R&D. David is deemed to have received a cash distribution from R&D in the amount of: **(Page 217)**

    a. $52,500. [This answer is incorrect. $52,500 is the cash contribution amount that Robert and David are each deemed to have made to the partnership, half of the liability to which the contributed property was subject.]

    b. $60,000. [This answer is incorrect. $60,000 is David's depreciated basis in the property.]

    c. $105,000. [This answer is correct. David is deemed to have received a cash distribution from R&D in the amount of the liability, which is $105,000.]

    d. $122,500. [This answer is incorrect. The shift in liabilities increases Robert's basis in his partnership interest from $70,000 to $122,500.]

11. Assume the same information in the self-study question above, except the contributed debt is nonrecourse. David's total gain is: **(Page 219)**

    a. $105,000. [This answer is incorrect. $105,000 is the amount of the fully recourse mortgage incurred to acquire the property.]

    b. $75,000. [This answer is incorrect. $75,000 is the total of the Section 704(c) minimum gain added to 50% of "excess" liabilities.]

    c. $30,000. [This answer is correct. $30,000 is the amount of David's total gain (or new basis) when the contributed debt is nonrecourse instead of fully recourse.]

    d. $45,000. [This answer is incorrect. $45,000 is the Section 704(c) minimum gain.]

12. An obligation would **not** be a liability for the purposes of IRC Sec. 752 in which of the following instances? **(Page 221)**

    a. It increases the basis of the obligor's cash. [This answer is incorrect. If the obligation either creates or increases the basis of any of the obligor's assets, including cash, the obligation is a liability for the purposes of IRC Sec. 752.]

    b. It provides for a prompt deduction to the obligor. [This answer is incorrect. The obligation is a liability for the purposes of IRC Sec. 752 if it gives rise to an immediate deduction to the obligor.]

    c. It gives rise to a penalty. [This answer is incorrect. If the obligation causes a penalty to occur, it qualifies as a liability for the purposes of IRC Sec. 752.]

    d. It provides for a non arm's-length transaction. [This answer is correct. A liability under Reg. 1.752-7 would not include a related party transaction.]

13. Which of the following statements regarding a partner/partnership liability or obligation is accurate? **(Page 222)**

    a. When a partner's liability is assumed by the partnership in connection with a contribution of property to the partnership, the liability that has been assumed is treated as having a built-in loss under the rules of IRC Sec. 704(c), Reg. 1.752-7(j)(2). [This answer is incorrect. The regulation that applies to treating the liability that has been assumed as having a built-in loss is Reg. 1.752-7(c)(1)(i), *not* Reg. 1.752-7(j)(2).]

    b. The amount of the built-in loss in (a) above is the amount of the Reg. 1.752-7 liability 5 business days prior to the date the partnership assumes such loss. [This answer is incorrect. The amount of the built-in loss in (a) above is the amount of the Reg. 1.752-7 liability *on the date* it is assumed by the partnership.]

c. Items of deduction or loss regarding the liability must first be allocated to the partnership to the degree of the built-in loss. [This answer is incorrect. Items of deduction or loss regarding the liability must first be allocated to the *contributing partner* to the extent of the built-in loss.]

d. After items of deduction or loss related to the liability have been allocated to the contributing partner, remaining deductions or losses are allocated among the other partners. [This answer is correct. Once items of deduction or loss related to the liability have been allocated to the contributing partner to the extent of the built-in loss, remaining deductions or losses are allocated among the rest of the partners. This allocation is carried out in accordance with allocation rules in Section 704(b).]

COPING WITH THE DISGUISED SALE RULES

The nonrecognition rule applies only to property contributions. It does not apply if the transaction is a sale. The substance of a transaction, not its form, determines whether a property transfer is treated as a contribution. If a contribution is followed closely by a distribution to the contributing partner, the transaction may be recast as a sale or exchange of property to the partnership or to the other partners. A contribution to the partnership of a target property by one partner and cash or other property by another partner with a distribution form the partnership of cash to the partner contributing the cash or other property is also subject to being recast as a sale under the disguised sale rules.

The classic example of this *disguised sale* is a contribution of appreciated property to the partnership followed by a distribution of cash to the contributing partner. A more subtle example of a disguised sale occurs when one partner surrenders part of his or her rights to future profits, and another partner obtains those rights by assuming future capital contribution obligations of the first partner. Additionally, constructive contributions and distributions arising from shifts in partnership liabilities (see Example 1-7) may cause a transaction to be treated as the sale of a partnership interest. If a contribution is recharacterized as part of a disguised sale, the contributor may recognize gain on what was expected to be a tax-free transaction. Taxpayers have unsuccessfully attempted to use extremely complex structures to avoid application of the disguised sale rules. See the findings in Chief Council Advice 200246014 and 200250013 and TAM 200301004.

Recognizing When a Disguised Sale of Property Takes Place

The disguised sale regulations provide that a property transfer from a partner to a partnership followed by a cash distribution from the partnership to a partner (or vice versa) is considered to be a sale of the property under certain circumstances. The transfer constitutes a sale only if both of the following conditions are met:

a. The transfer of money or other consideration would not have been made but for the transfer of the property.

b. If the transfers are not simultaneous, the subsequent transfer (either of money or property) does not depend on the entrepreneurial risks of partnership operations.

The following facts and circumstances may prove the existence of a disguised sale:

a. The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of the earlier transfer.

b. The transferor has a legally enforceable right to the subsequent transfer.

c. The partner's right to receive the transfer of money or other consideration is secured in any manner (taking into account the period during which it is secured).

d. Any person has made or is legally obligated to make contributions to the partnership to permit the partnership to make the transfer of money or other consideration.

e. Any person has loaned or has agreed to loan the partnership the money or other consideration necessary to permit it to make the transfers, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations.

f. The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur the debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal responsibility for the debt).

g. The partnership holds money or other liquid assets, beyond the reasonable needs of the business, which are expected to be available to make the transfer (taking into account the income that will be earned from those assets).

h. Partnership distributions, partnership allocations, or control of partnership operations is designed to affect an exchange of the burdens and benefits of property ownership.

i. The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits.

j. The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

Note that the disguised sale regulations apply to deemed sales from the partner to the partnership, from the partnership to a partner, and among the partners. The remainder of this discussion assumes the disguised sale is a deemed sale of property from the contributing partner to the partnership.

Example 1-12: Contribution and simultaneous distribution treated as a disguised sale.

Kristen transfers a tract of raw land to Madison Investors Partnership in exchange for a partnership interest. On the same day, Madison transfers $2 million cash to Kristen. At the time of the transfer, the land has a FMV of $3 million and an adjusted basis to Kristen of $1.5 million.

The contribution and distribution are treated as a partial sale by a third party to the partnership rather than as a contribution of property by Kristen and a distribution of cash by Madison. Because the cash Kristen receives is less than the property's FMV, the transfer is treated as a partial sale (of two-thirds of the land) and partial contribution (of one-third). Kristen allocates her $1.5 million basis in the transferred property between the sale and the contribution and recognizes a $1 million gain from the partial sale [$2,000,000 − ($1,500,000 × $2,000,000 ÷ $3,000,000)]. Kristen's initial basis in her partnership interest is $500,000—the remaining basis allocable to the land deemed contributed.

Bifurcation or Aggregation of Transfers. Under the disguised sale rules, transfers can be bifurcated or aggregated. If the consideration transferred to a partner is less than the FMV of the contributed property, the transfer is treated as part sale and part contribution. The regulations clarify that for purposes of applying the disguised sale rules, transfers resulting from the technical termination of a partnership under IRC Sec. 708(b)(1)(B) are disregarded.

Effect on Other Code Sections. If a transaction is treated as a disguised sale under IRC Sec. 707, it is treated as a sale under all other Code provisions, such as IRC Secs. 453 (installment sales), 483 (unstated interest rule), 1001 (determination of gain or loss), 1012 (basis), 1031 (like-kind exchange), and 1274 [the original issue discount (OID) rules]. For instance, a disguised sale that otherwise meets the requirements of IRC Sec. 1031 is provided nonrecognition treatment. In addition, the recharacterization of the transaction from a contribution to a disguised sale affects the partner's basis in his or her partnership interest and the partnership's basis in the property.

Example 1-13: Applying the OID rules to a contribution and deferred distribution treated as a disguised sale.

Reggie is a member in XYZ Properties Partnership. On January 1, 2010, Reggie contributes property with a $170,000 basis and a $500,000 FMV to XYZ. On December 31, 2010, XYZ transfers $400,000 cash to Reggie in what is determined to be a disguised sale. Reggie is treated as having sold a portion of the contributed property to XYZ for an obligation to transfer $400,000 to him 12 months later.

Since the obligation does not bear interest, the OID rules of IRC Sec. 1274 apply. Assuming the applicable federal rate is 10% (for simplicity's sake), $37,188 of the $400,000 distributed to Reggie is deemed to be interest (based on the present value of the payment using 10% compounded semiannually). On Reggie's 2010 individual income tax return, he reports interest income of $37,188 and a gain on sale of the contributed property of $239,456, computed as follows [Reg. 1.707-3(f), Example 2]:

Amount realized ($400,000 − $37,188 OID)	$ 362,812
Basis in property deemed sold [$170,000 × ($362,812 ÷ $500,000)]	(123,356)
Gain on deemed sale	$ 239,456

Applying the Rules to Nonsimultaneous Transfers

A disguised sale is considered to take place on the date the partnership is determined to be the owner of the transferred property. In situations where the corresponding transfer to the partner takes place at a later date, the partner is considered to have received an obligation from the partnership on the date the partnership acquired ownership of the property. Nonsimultaneous transfers should be reviewed to determine if IRC Sec. 1274 is applicable. IRC Sec. 1274 establishes the issue price of any obligation that does not bear interest (if the payments are received more than six months after the sale date). Example 1-14 provides an example of the interaction of IRC Secs. 707 and 1274.

Example 1-14: Accounting for a disguised sale when the transfers do not take place simultaneously.

Fred and Barney form Bedrock Construction, a 50/50 general partnership. On April 15, 2010, Fred made his initial contribution to the partnership of land that had a $4 million FMV and a $1.2 million adjusted tax basis. On the same date, Barney contributed $4 million cash. One year later, on April 15, 2011, the partnership transferred $3 million to Fred. The partnership's accountant has informed Fred that this transaction will be treated as a disguised sale under Reg. 1.707-3.

The transaction is treated as if, on April 15, 2010, Fred sold a portion of the land to the partnership in exchange for an obligation to transfer $3 million to him one year later. The gain is reportable under the installment method of IRC Sec. 453. Because this obligation does not bear interest and is payable more than six months after the sale date, IRC Sec. 1274 applies.

Fred's amount realized from the receipt of the partnership's obligation equals $2,721,088—the imputed principal amount of the partnership's obligation to transfer $3 million to him. This was computed by taking the present value on April 15, 2010 of a $3 million payment due one year later, using a discount rate of 10%, compounded semiannually. (It is assumed in this example that 10% is the applicable federal short-term rate for April 2010.) Fred is considered to have sold only $2,721,088 of the FMV of the land. The remainder of the $3 million payment ($278,912) is subject to the original issue discount provisions of IRC Sec. 1272. These provisions require the buyer and seller to treat the amount as interest over the term of the note.

Fred recognizes the following gain:

Amount realized	$ 2,721,088
Less the portion of basis in property 2 determined to have been sold:	
$1,200,000 basis × ($2,721,088 FMV of portion sold / $4,000,000 total FMV)	(816,327)
Gain recognized	$ 1,904,761

In his capacity as a partner, Fred is considered to have contributed to the partnership $1,278,912 of the FMV of the land with a $383,673 adjusted tax basis (his total basis of $1.2 million less $816,327, the amount allocated to the portion deemed sold). Fred's basis in his partnership interest is $383,673. The portion of the land that was deemed transferred to the partnership under the disguised sale rules will have a $2,721,088 basis in the hands of the partnership. Further, the partnership will have an additional basis in the land treated as a contribution by Fred of $383,673, for a total basis of $3,104,761.

Two-year Rule. Although the regulations establish a facts-and-circumstances test for determining if a transaction is a disguised sale, transfers made within a two-year period are presumed to be a sale, and transfers made more than two years apart are presumed not to be a sale. (Note that both of these presumptions are rebuttable and will not stand if the facts and circumstances clearly establish the transaction was or was not a sale.)

Example 1-15: Analyzing the consequences of a contribution followed by a distribution.

Hansel and Harold form a 50/50 general partnership, OW Partners, on July 1, 2010 to build and develop a complex of office/warehouse buildings on a tract of land owned by Harold. Upon formation, Hansel contrib-

uted $2 million cash, and Harold contributed land with a $1 million adjusted basis and $2 million FMV. The projected construction cost is $10 million, which will be funded by Hansel's $2 million contribution and an $8 million recourse construction loan secured by the land and improvements. In connection with the funding of the construction loan, Harold has agreed to guarantee the completion of the project for $10 million (i.e., to complete the project and to fund any construction costs in excess of $10 million).

The partnership has also received a commitment for a nonrecourse permanent loan to be funded upon completion of the buildings, which is projected to be on or near September 1, 2012. The permanent loan will be the lesser of $10 million or 80% of the appraised value of the land and buildings at the time the permanent loan is closed. The partnership agreement provides that the permanent loan will be used to retire the construction loan, with any excess proceeds of the construction loan to be distributed to Harold at least 26 months after the transfer of the land to the partnership. The real estate market is soft and it is anticipated that 80% of the appraised value will exceed $8 million on the date the permanent financing is closed only if the buildings have achieved 50% occupancy.

The buildings are completed ahead of schedule on August 15, 2012. At that time 80% of the appraised value of the land and buildings is only $9 million. The partnership closes on the permanent loan on August 16, 2012 and pays off the $8 million construction loan and distributes $1 million to Harold.

Harold's transfer of the land to OW Partners and the subsequent $1 million distribution from the partnership to Harold occur more than two years apart. Under the general rule, transfers occurring more than two years apart are presumed not to be a sale unless the facts and circumstances clearly indicate otherwise. In analyzing the facts and circumstances of this transaction, the following must be determined:

a. Would Harold have received the $1 million distribution had he not transferred the property?

b. Was the subsequent $1 million distribution to Harold dependent on the entrepreneurial risks of partnership operations? In other words, if the partnership had performed poorly would Harold still have received the money?

The $1 million distribution to Harold would not have been made if he had not transferred the property to the partnership. In addition, at the time Harold transferred the land to the partnership, he had a legally enforceable right to receive a distribution from the partnership at a specified time in an amount equal to the excess of the permanent loan proceeds over $8 million. In this case, however, there was a significant risk that the permanent loan (for 80% of the property's appraised value) would not exceed $8 million and, therefore, the permanent loan proceeds would not be sufficient to make the distribution to Harold. Thus, the agreed-upon distribution to Harold depended on the performance of the partnership, so the disguised sale rules do not apply.

Example 1-16: Analyzing whether a subsequent transfer depends on the entrepreneurial risks of partnership operations.

Assume the same facts as in Example 1-15, except that the partnership secures a commitment for a $10 million permanent loan without regard to the project's appraised value. The full $10 million will be funded when the project is certified to be 95% complete. Under these facts, at the time Harold transfers the land to the partnership, the $2 million distribution to Harold is not dependent on any entrepreneurial risk because:

- During the period before the permanent loan is funded, the bank's obligation to make the permanent loan in an amount necessary to fund the distribution is not subject to contingencies related to partnership operations. Therefore, Harold had no entrepreneurial risk.

- After the permanent loan is funded, the partnership holds liquid assets—the cash loan proceeds in excess of the construction loan amount—sufficient to make the distribution to Harold.

The facts clearly establish that Harold's transfer of the land is part of a disguised sale transaction. Harold is treated as if he sold the land to the partnership on the contribution date. Since Harold retains liability for half the recourse permanent loan under IRC Sec. 752, he is deemed to have sold only half of the property in the disguised sale. Therefore, Harold is treated as having sold land with a $500,000 basis to the partnership for $1

million—and he will recognize a $500,000 gain. The partnership will have a $1.5 million basis in the contributed land—a $1 million basis in the purchased half and a $500,000 basis in the contributed half.

What if there was no guarantee that the improvements would be completed or that the cost of the improvements would not exceed $10 million? If there was a significant risk either that the improvements would not be completed or that the completion costs would exceed $10 million, Harold's contribution of the land would not be treated as part of a disguised sale. If the improvements are not completed, the bank is not obligated to fund the permanent loan, and if construction costs are in excess of $10 million, there will be fewer or no funds available to distribute to Harold. Therefore, any subsequent distribution to Harold is dependent on the entrepreneurial risks of partnership operations.

Basis of the Transferor Partner's Interest in the Partnership

Application of the disguised sale rules to a transaction changes the basis of the transferor partner's interest in the partnership. The basis of the transferred property treated as sold is not a part of the partner's interest in the partnership. The payment the partner receives does not reduce the basis in his or her partnership interest. The partnership would have a cost basis in the property instead of a carryover basis from the partner. The regulations do not provide guidance about how to account for the collateral consequences of the recharacterization of the transfer, which is removed from the partner's capital account. The disguised sale rules could affect the special allocations of items to the partners, especially if a retroactive change to the capital account is necessary. Since the regulations do not provide any direction regarding these issues, the partnership agreement should denote the need to adjust partner allocations if the disguised sale rules in IRC Sec. 707(a)(2)(B) apply.

Structuring Payments to Avoid Disguised Sale Treatment

Certain types of payments made by a partnership to a partner are not considered part of a disguised sale transaction. The following types of payments are not deemed to be sale proceeds under the disguised sale rules (Reg. 1.707-4):

a. Guaranteed payments made to a partner for the use of capital that are reasonable in amount.

b. A preferred return (a preferential distribution of cash flow matched by an allocation of income or gain) to a partner that is reasonable in amount.

c. A distribution of operating cash flow.

d. A reimbursement of preformation expenses.

Guaranteed Payment or Preferred Return

A guaranteed payment or preferred return is considered reasonable if it is made pursuant to a written partnership agreement and does not exceed an amount computed using the following formula:

Unreturned Capital
(at Beginning of Year or on
a Weighted Average Basis) × Safe Harbor Interest Rate

A partner's unreturned capital is defined as the amount of cash and FMV of property (net of liabilities) contributed to the partnership less the amount of cash and FMV (net of liabilities) of property distributed from the partnership. Unreturned capital includes cumulative unpaid guaranteed payments or preferred returns from prior years. The safe harbor interest rate is equal to 150% of the highest applicable federal rate during the period from the time the partner first has a right to the payment (usually the partnership agreement date) through the end of the current tax year.

Planning Tip: When interest rates are quite low for an extended period, a recently formed partnership could have difficulty satisfying the safe harbor rules for reasonable guaranteed payments. In the real world, partners may be

unwilling to accept 150% of the highest AFR as adequate compensation. As a result, some perfectly legitimate guaranteed payments could exceed the safe harbor rate. Under the disguised sale rules, such excessive guaranteed payments are presumed to be consideration (i.e., proceeds from a disguised sale) unless the facts and circumstances clearly indicate they are actually guaranteed payments for the use of capital. Such circumstances could include, for example, specifying in the partnership agreement a minimum interest rate for guaranteed payment calculation purposes whenever 150% of the highest AFR falls beneath that minimum rate. In addition, all the other safe harbor guidelines for reasonable guaranteed payments explained earlier should be followed in order to make the case that payments are clearly guaranteed payments under the facts and circumstances standard.

In general, guaranteed payments for capital are not considered payments under the disguised sale rules. A payment to a partner that the parties treat as a guaranteed payment for capital is presumed to be a guaranteed payment for capital unless the facts and circumstances establish otherwise. The payment must be reasonable and determined without regard to the partnership's income. The payments are basically a return on investment and should not be designed to liquidate a partner's interest in the partnership. In addition, the payments should be made for the use of capital after the date that this provision is added to the partnership agreement.

The characterization of a payment in the partnership agreement as a guaranteed payment for the use of capital does not automatically mean it will be treated as a guaranteed payment for tax purposes. Any payment designed to liquidate all or a part of a partner's interest in property contributed to the partnership (rather than to provide the partner with a return on an investment in the partnership) is not considered a guaranteed payment. Additionally, guaranteed payments and preferred returns are excluded from treatment as sales proceeds under the disguised sale rules only after they have been designated as guaranteed payments and preferred returns in the partnership agreement. An amendment to the agreement will not retroactively recharacterize such payments.

Guaranteed payments for services are not considered part of a disguised sale of property under the facts and circumstances test, because such payments are not related to a property transfer by a partner.

Example 1-17: Structuring guaranteed payments to avoid disguised sale treatment.

Michael and Lisa Marie are forming the MLM Partnership, a 50/50 general partnership, to operate a recording studio. Michael is contributing a building worth $100,000 that has a $20,000 adjusted basis and recording equipment worth $4,000 that has a $10,000 adjusted basis. The partnership agreement has a written provision that Michael is to receive a guaranteed payment for three years for the use of his capital. The guaranteed payment is computed at 10% (compounded annually) of the FMV of the property transferred by Michael.

When the partnership agreement is ready to be signed, the applicable federal rate (AFR) for short-term obligations compounded annually is 6%. This is the highest it has been in the last three years. (Assume the AFR is not anticipated to increase anytime soon.)

To estimate if the payments are reasonable, the practitioner should multiply Michael's beginning of the year unreturned capital by the safe harbor interest rate. (Since this is an estimation and no other distributions are anticipated other than cash flow distributions, the weighted average capital balance for the year should be the same as the beginning of the year balance.) Michael's unreturned capital, in this case, will equal the FMV of the property he contributed, which is $104,000. The amount that is estimated to be reasonable under Reg. 1.707-4(a)(3)(ii) is computed as follows:

Michael's unreturned capital at the beginning of the year	$ 104,000
Multiplied by (1.5 × 6%)	× 9%
Reasonable guaranteed payment	$ 9,360

Michael is currently entitled to a guaranteed payment of 10% (compounded annually) of the FMV of the transferred property in each of the three years following the transfer. In the initial year, the amount would be $10,400 ($104,000 multiplied by 10%). Based on this estimate, the guaranteed payment Michael is entitled to receive does not meet the definition of a reasonable amount. Unless the facts and circumstances clearly establish that the transfer is a guaranteed payment for capital, the transfer may run afoul of the disguised sale rules under Reg. 1.707-3.

Knowing the current structure of payments to Michael exceeds the limits allowed by the regulations, it might be appropriate to revise the payment structure. Guaranteed payments made outside of the two-year period are assumed not to be part of disguised sale transactions. Extending the payments over a longer period, and thereby reducing the annual payment, would help ensure that the amounts would be reasonable in the first two years.

In the preceding example, if the payments were recharacterized as a disguised sale, Michael would have been treated as if he had sold a portion of each of the properties transferred to the partnership. Under former Reg. 1.707-3(e), if a partner transferred more than one property to the partnership pursuant to a plan, such as Michael did, the amount realized from consideration that he receives from the partnership would be allocated between the properties transferred based on their relative FMVs. This was intended to prohibit a partner from selling property with a high basis and contributing other property with a low basis to the partnership. This rule has been deleted from the final regulations, and no further guidance has been issued.

Example 1-18: Avoiding disguised sale treatment when forming a partnership by using guaranteed payments.

Erica and Adam are forming the Enchantment Partnership. Adam contributes property with a $100,000 FMV and a $20,000 tax basis for his partnership interest. Erica does not make any capital contribution for her partnership interest, but will be responsible for managing the day-to-day operations.

The partnership agreement provides that Adam will receive guaranteed payments of $8,333 per year for the first four years of operations for the use of his capital. These payments are determined without regard to partnership income. In addition, income and loss will be allocated 75% to Adam and 25% to Erica, and partnership cash flow (computed before the guaranteed payment) is distributed accordingly. Adam's guaranteed payments will be paid entirely out of Erica's share of the partnership's cash flow. If her portion of the cash flow is insufficient, she must make a contribution to the partnership to make up for the shortfall, even if the partnership is liquidating. At the time of the partnership formation, Erica or the partnership could have borrowed $25,000 payable in four years at the current market interest rate of 12% compounded annually. The highest applicable federal rate in effect at the time the partnership is formed is 10% compounded annually.

The payments to Adam meet all of the specifications to be considered guaranteed payments and are presumed to be such unless the facts and circumstances clearly establish they are not guaranteed payments for capital and are part of a sale.

For the first four years of operation, Adam's total guaranteed payments equal $33,332. Assuming the character of the payments is respected, Adam would be allocated $25,000 ($33,332 × 75%) of the deductions claimed by the partnership for guaranteed payments. These deductions reduce his capital account by $25,000 that would not otherwise have been incurred. The guaranteed payments in effect offset approximately $25,000 of the contribution made to Adam's capital account for the property he transferred to the partnership. His capital account would be what it would have been had he only contributed 75% of the property to the partnership.

Erica's funding the guaranteed payments to Adam adjusted her capital account to the equivalent of what it would have been had she contributed 25% of the property. Moreover, a $25,000 loan requiring equal payments of principal and interest over four years at the current market interest rate of 12% (compounded annually) would result in annual payments of principal and interest of $8,230.86. As a result, the guaranteed payments effectively place the partners in the same economic position in which they would have been if Erica had purchased a 25% interest in the property from Adam (financed at the current market interest rate) and then both of them had contributed their share of the property to the partnership.

The presumption that the transfers to Adam are guaranteed payments for capital is negated because the facts and circumstances clearly establish that the transfers are part of a sale and are not guaranteed payments for capital. Under Reg. 1.707-3(a), Adam and the partnership are treated as if he had sold a 25% interest in the property to the partnership in exchange for a promissory note evidencing the partnership's obligation to make the guaranteed payments. Adam will recognize gain on the sale of 25% of his interest in the property that equals $20,000 ($25,000 sale price less 25% × 20,000 basis).

The guaranteed payment provision should be restructured to prevent it from being recharacterized into a disguised sale. Perhaps the guaranteed payments could be increased to establish that there is no correlation between them and the income allocation between Adam and Erica. Another option would be to remove the restriction of having the guaranteed payments funded; however, the amount would still need to be funded completely by Erica's cash flow. Of course these suggestions would change the economic outcome of the transaction.

Preferred Returns

Partners frequently receive a preferred return or preferential distribution of cash flow under the terms of the partnership agreement. These payments are usually intended to compensate partners who have invested capital in the partnership. Such payments are not considered payments in exchange for property under the disguised sale rules if they pass the tests established for guaranteed payments discussed previously in this section.

Distribution of Operating Cash Flow

A distribution is considered to be from operating cash flow if it does not exceed an amount calculated using the following formula:

$$\frac{\text{Cash or Other Property Treated as Sales Proceeds}}{\text{FMV of the Property, Net of Qualified Liabilities}}$$

Net cash flow is computed as follows:

Net Cash Flow = Taxable Income
+ Tax-exempt Interest
+ Depreciation
+ Amortization
+ Other Noncash Expenses
− Principal Payments
− Capital Reserves
− Capital Expenditures (when made other than from reserves or borrowings, the proceeds of which were not included in operating cash flow)
− Other Nontaxable Cash Expenses

A partner's profit percentage for determining his or her distributive share of operating cash flow is the lesser of the partner's overall profit percentage for the current year or the partner's overall profit percentage for the life of the partnership. The regulations provide a safe harbor for determining the partner's profit percentage—the partner may use the smallest percentage interest (under the terms of the partnership agreement) in any material item of partnership income or gain for the three-year period beginning with the current tax year. Payments that qualify as guaranteed payments for capital, preferred returns, and distributions of operating cash flow continue to qualify as such, even if paid in subsequent years.

Reimbursing Preformation Expenses

The disguised sale rules do not apply to reimbursement of the partnership's preformation expenses if the distribution reimburses a partner for expenses incurred during the two-year period preceding the transfer, and the expenses were incurred with respect to one of the following:

a. Organization and syndication costs of the partnership.

b. Contributed property—but only in an amount that does not exceed 20% of the FMV of the property at the time of contribution. (The 20% limitation does not apply if the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the property on the contribution date.)

Rev. Rul. 2000-44 indicates that when a corporation acquires the assets of another corporation (in this case the assets of its subsidiary) in a transaction under IRC Sec. 381(a) (certain corporate acquisitions where tax attributes

are carried over to the succeeding corporation) and then contributes the assets to the partnership, the successor will succeed to the status of the other corporation for applying the exception for reimbursements of preformation expenditures and determining whether a liability is a qualified liability under the disguised sale rules.

Dealing with the Treatment of Liabilities in a Disguised Sale

The regulations provide special rules for the treatment of liabilities incurred or transferred in connection with a disguised sale. These rules are designed to attack certain kinds of transactions, including situations where the partner incurs debt in anticipation of the transfer of property to the partnership, and the partnership subsequently assumes the debt or takes the property subject to the debt. In general, a partnership's assumption of a partner's liability is equivalent to a withdrawal from the partner's interest in that partnership.

What Are Qualified Liabilities? The treatment of liabilities hinges on whether they are qualified liabilities or other liabilities. Qualified liabilities include:

a. Debt incurred more than two years before the transfer (or agreement to transfer) that has encumbered the transferred property throughout the two-year period.

b. Debt incurred within two years before the transfer (or agreement to transfer) but not incurred in anticipation of the transfer. Such debt must have encumbered the property since it was incurred.

c. Debt incurred to acquire or improve the property.

d. A liability incurred in the ordinary course of a trade or business operated in connection with the property (but only if substantially all the assets related to that trade or business are transferred).

Debt (other than acquisition debt, improvement debt, and trade or business debt) incurred within two years of the transfer (or an agreement to transfer) and assumed by the partnership in connection with the transfer is presumed to have been incurred in anticipation of the transfer unless the facts and circumstances clearly indicate otherwise. When a disguised sale is deemed to be from a partnership to a partner, qualified liabilities include any liability that has been in existence for more than two years, regardless of whether it has encumbered partnership property.

A recourse liability is considered a *qualified liability* only to the extent it does not exceed:

The FMV of the transferred property,

Less: Other liabilities senior in priority that encumber the transferred property,

Less: Other liabilities senior in priority that are acquisition or improvement debt allocable to the transferred property,

Less: Other liabilities senior in priority that are trade or business liabilities incurred in connection with the transferred property.

Regulations address abusive transactions involving the contribution of liabilities to a partnership and subsequent disposition of the partnership interest. These transactions accelerate or duplicate losses through the assumption of (or transfer of assets subject to) liabilities. While the proposed regulations specifically stated that the assumption of a Reg. 1.752-7 liability would not be treated as an assumption of a liability or as a transfer of cash under the disguised sale rules, this provision was not included in the final regulations.

If a property transfer (without taking into account transferred debt) is not treated as a disguised sale, qualified liabilities are not deemed to be consideration. If a transfer would be treated as a disguised sale without taking into account transferred debt, qualified liabilities are deemed to be consideration up to an amount equal to the lesser of:

a. The amount of such debt that is shifted to the other partners, or

b. the amount of such debt multiplied by the following fraction:

$$\frac{\text{Cash or Other Property Treated as Sales Proceeds}}{\text{FMV of Transferred Property} - \text{Qualified Liabilities Encumbering Transferred Property}}$$

Thus, the transfer of property subject to qualified liabilities will never cause the disguised sale rules to come into effect unless cash or other property is also distributed.

If property subject to liabilities that are not qualified liabilities is transferred, the liabilities are deemed to be consideration to the extent that the transferring partner is relieved of liability.

Example 1-19: Analyzing a disguised sale transaction that involves the transfer of qualified liabilities and cash.

Frank is a 25% partner in Texas Investments (TI), a general partnership. On July 1, 2010, he contributes Longacre, an undeveloped tract of land, to TI. At that time, the property's FMV is $250,000, and his tax basis in the property is $100,000. The property is encumbered by a $100,000 recourse loan that is assumed by the partnership. The liability was incurred in 2005, when Frank purchased the property. Also in connection with the property transfer from Frank to the partnership, TI distributes $50,000 to Frank.

Frank's contribution and the related distribution will be treated as a disguised sale because the cash transfer was made to Frank with respect to his property transfer to TI, the transfer was within a two-year period, and facts and circumstances do not indicate that the transaction was not a sale.

The $100,000 liability transferred to the partnership is a qualified liability because it was incurred more than two years before the assumption of the liability by the partnership and has encumbered the property for that entire period. However, since TI transferred $50,000 to Frank in addition to assuming the qualified liability, all or a portion of the liability is treated as consideration. Under Reg. 1.707-5(a)(5), the amount of the liability assumed by TI that is treated as consideration is the lesser of (1) the amount of the qualified liability assumed by Frank's partners, or (2) the amount of the debt multiplied by the following fraction:

$$\frac{\text{Cash or Other Property Treated as Sales Proceeds}}{\text{FMV of the Property, Net of Qualified Liabilities}}$$

The amount of the qualified liability assumed by Frank's partners is $75,000 (the $100,000 note less $25,000, Frank's 25% share of the liability). This is more than the amount determined under the formula set out under the preceding item (2) {$100,000 × [$50,000 ÷ ($250,000 − $100,000)] = $33,333}. Therefore, the amount of the qualified liability treated as consideration is $33,333.

Frank is considered to have sold $83,333 of the value of the property to the partnership in exchange for $50,000 cash and the relief of a $33,333 liability. He will recognize a $50,000 gain, equal to the $83,333 sales price less his $33,333 basis in the property sold [$100,000 × ($83,333 ÷ $250,000)].

Determining a Partner's Share of Partnership Liabilities for Disguised Sale Purposes. For purposes of applying the disguised sale regulations, a partner's share of partnership liabilities is determined under the following rules:

a. Recourse liabilities are shared under the provisions of IRC Sec. 752.

b. Nonrecourse liabilities are allocated under the rules for sharing excess nonrecourse liabilities under IRC Sec. 752. These rules require such liabilities to be shared based on the partners' profit percentages (taking into account all facts and circumstances). The partners' profit percentages may be specified in the partnership agreement as long as the specified percentages are consistent with the allocation of some other significant item of partnership income or gain.

Example 1-20: Treating partnership's assumption of nonrecourse liability encumbering transferred property as a disguised sale.

In June 2010, Mark and Beverly form Birdville Investors Partnership to provide leasing services for commercial office space. Mark contributes $600,000 cash, and Beverly contributes an office building with a $1.2 million FMV and a $500,000 adjusted basis. The office building is encumbered by a $600,000 nonrecourse liability Beverly incurred in 2009 to finance the acquisition of other property. All partnership items are allocated equally between Mark and Beverly.

The nonrecourse liability secured by the office building is not a qualified liability, since it was incurred within the two-year period before contribution and is not acquisition debt. Therefore, the assumption of a portion of the liability by Mark is treated as consideration to Beverly. Beverly's share of the nonrecourse debt (under a facts-and-circumstances analysis) is 50%. Beverly is deemed to have received a cash distribution equal to 50% of the liability, or $300,000. A disguised sale has occurred even though Beverly has not received an actual cash distribution.

Beverly is considered to have sold a 25% interest in the building (which had a $1.2 million FMV) to the partnership for $300,000. Birdville has purchased 25% of the office building for $300,000 and received the other 75% of the building as a capital contribution. Its adjusted basis in the building is $675,000 [$300,000 basis in the purchased portion + $375,000 remaining basis in the contributed portion ($500,000 − $125,000 attributed to 25% interest sold)].

A subsequent reduction in a partner's share of a liability assumed by the partnership in connection with a transfer may be considered part of a disguised sale if the reduction is anticipated at the time of the transfer and is part of a plan to minimize the extent to which the assumption of debt is treated as part of the sale.

Netting of Liabilities. The regulations do not allow netting between existing and precontribution liabilities in the determination of what is consideration for a disguised sale. If the property that the partner transfers to the partnership is subject to a nonqualified liability, the partner receives credit for the amount of the nonqualified liability that is allocated to him through the partnership. He does not receive any credit for his portion of the existing partnership liabilities that are allocated to him.

The regulations allow the netting of both qualified and nonqualified precontribution liabilities that have been transferred to the partnership by more than one partner pursuant to a plan. If a partnership assumes or takes property subject to the liabilities of more than one partner according to a plan, a partner's share of the liabilities assumed, or taken subject to, by the partnership pursuant to a plan immediately after the transfers, equals the sum of that partner's share of the liabilities (other than that partner's qualified liabilities) assumed, or taken subject to, by the partnership according to the plan. See Example 1-21 for an example of how liabilities are netted.

Limited partners generally have limited liability under state law for partnership liabilities and do not normally have any economic risk of loss for partnership recourse debts. If a limited partner is required to contribute to the partnership to pay the liability, pay the creditor, or repay another partner, the limited partner may have the economic risk of loss for that liability.

Example 1-21: Transfers of encumbered property to a partnership by more than one partner pursuant to a plan.

In March 2010, the Whitewater Partnership, a real estate development operation, approached Bill and Hillary about two pieces of real estate they owned. In exchange for the property, Bill and Hillary would receive limited partner interests in Whitewater. Pursuant to an integrated plan, the transfers were scheduled to take place in April 2010, at which time both Bill and Hillary would each become one-third limited partners in Whitewater.

At that time, Bill's property, Property 1, had a $100,000 FMV, a $60,000 adjusted tax basis, and a $60,000 nonrecourse liability. Bill obtained the note in March 2010 to pay off his personal credit cards. Property 2, owned by Hillary, had a $100,000 FMV and a $40,000 adjusted basis. Hillary obtained a $70,000 recourse note in March 2010 that was secured by Property 2. She used the proceeds to redecorate her home. The partnership takes Bill's property subject to liability 1 and assumes liability 2 as part of the transaction. Bill has additional capital contribution requirements of $35,000.

Since Bill and Hillary transferred the two properties to Whitewater pursuant to a plan, Reg. 1.707-5(a)(4) applies, and the two liabilities (both of which are not qualified) assumed or taken subject to by the partnership are netted together to determine the amount of consideration Bill and Hillary received from the partnership.

According to Regs. 1.707-5(a)(2)(ii) and 1.752-3(a), which determine a partner's share of a nonrecourse liability, Bill and Hillary are allocated $20,000 of liability 1. Bill's share of liability 2 is $35,000 and Hillary's share is zero, according to Regs. 1.707-5(a)(2)(i) and 1.752-2, which determine a partner's share of a recourse liability. As the following computation shows, Whitewater has transferred consideration of $5,000 to Bill and $50,000 to Hillary.

Amount realized by Bill:	
Liability 1 taken subject to by Whitewater	$ (60,000)
Bill's share of liability 1	20,000
Bill's share of liability 2	35,000
Total	$ (5,000)
Amount realized by Hillary:	
Liability 2 assumed by Whitewater	$ (70,000)
Hillary's share of liability 1	20,000
Hillary's share of liability 2	—
Total	$ (50,000)

Under Reg. 1.707-3, Bill is treated as having sold $5,000 of the FMV of Property 1, and Hillary is treated as having sold $50,000 of the FMV of Property 2. The respective gains on the portion of the transfers treated as sales under the disguised sale rules are computed as follows:

Amount realized by Bill	$ 5,000
Less the portion of basis in Property 1 determined to have been sold:	
$60,000 basis × ($5,000 FMV realized / $100,000 total FMV)	(3,000)
Gain recognized by Bill	$ 2,000
Amount realized by Hillary	$ 50,000
Less the portion of basis in Property 2 determined to have been sold:	
$40,000 basis × ($50,000 FMV realized / $100,000 total FMV)	(20,000)
Gain recognized by Hillary	$ 30,000

Each contributing partner's precontribution share of assumed liabilities generally is netted against that partner's postcontribution share of such liabilities for purposes of the disguised sale rules. As a result of netting the liabilities as allowed by Reg. 1.707-5(a)(4), each partner is credited with his or her share of the precontribution liabilities to determine what consideration will be realized. In Bill's case, the ability to net his portion of the liabilities against the partnership's assumption of liability 1 reduced the consideration he is considered to have received by $35,000. This effectively reduces the FMV of the portion of Property 1 that he sold from $40,000 to $5,000. Because Hillary was not allocated any of liability 2, she is treated as having sold a larger percentage (compared to Bill) of Property 2 to the partnership under the disguised sale rules.

Bill's and Hillary's partnership interests will have a basis of $57,000 and $20,000, respectively, which is the portion of the properties that is considered to have been contributed by them.

If both of the liabilities assumed had been qualified in the preceding example, neither Bill nor Hillary would have been treated as having received any consideration. Reg. 1.707-5(a)(5)(i) indicates that if a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership's assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale.

Incurring Liabilities Subsequent to the Partnership Receiving the Contributed Property. If a partner contributes property to a partnership and the partnership subsequently incurs a liability and within 90 days uses the proceeds to make a distribution to the contributing partner, the transaction is considered a disguised sale. Whether the distribution is allocable to the proceeds of the liability is determined using the interest-tracing rules of Temp. Reg. 1.163-8T. The distribution is treated as consideration only to the extent the amount distributed exceeds the partner's allocable share of the partnership liability.

Effect in Tiered Partnership Situations. If a lower-tier (subsidiary) partnership assumes the liability of an upper-tier (parent) partnership, the transferred liability retains the same character as a qualified or nonqualified liability it had in the hands of the upper-tier partnership.

Required Disclosure

The disguised sale regulations require tax return disclosure (by the transferor of the property) in either of the following situations:

a. A partner transfers property to a partnership and the partnership transfers money or other property to the partner within two years, the partner does not treat the transfer as a disguised sale, and the transfer of money or other consideration to the partner is not considered a guaranteed payment for capital, a preferred return, or a distribution of operating cash flow. (This also applies to situations where the partnership transfers property to the partner and the partner subsequently contributes cash to the partnership.)

b. A partner treats a liability incurred as a qualified liability less than two years before the transfer.

If more than one partner transfers property to a partnership in a transaction subject to the disguised sale rules, disclosure can be made by the partnership on behalf of all the transferors, rather than by each transferor separately.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. A property transfer from a partner to a partnership (or vice versa) that is followed by a cash distribution by the other party to the transaction is considered to be a sale of the property if two conditions are met. Which of the following is one of those two conditions that require application of the disguised sale rules?

    a. The transfer of money or other consideration would not have occurred if the transfer of the property had not occurred.

    b. If the transfers are not simultaneous, the subsequent transfer of money depends on the entrepreneurial risks of partnership operations.

    c. If the transfers are not simultaneous, the subsequent transfer of property depends on the entrepreneurial risks of partnership operations.

15. Of the following, which one may confirm the existence of a disguised sale?

    a. The transferor does not have a legal right to the subsequent transfer.

    b. The partnership has not incurred debt to acquire money/other consideration needed for the transfer.

    c. Control of partnership operations is designed to affect an exchange of the burdens/benefits of property ownership.

    d. The transfer of money/other consideration by the partnership to the partner is comparable to the partner's continuing interest in partnership profits

16. A disguised sale treatment may be avoided as a result of all the following actions **except**:

    a. Guaranteed payments reasonable in amount made to a partner in return for the use of capital.

    b. Operating cash flow has been distributed.

    c. The partner's right to receive the transfer of money is secured in any manner.

    d. There has been a reimbursement of preformation expenses.

17. Company XYZ's net cash flow is _________ based on the following information:

    Taxable income: $200,000; Tax-exempt interest: $5,450; Depreciation: $22,200; Amortization: $7,425; Other noncash expenses: $3,380; Principal payments: $60,775; Capital reserves: $80,275; Capital expenditures: $35,000; and other nontaxable cash expenses: $2,500.

    a. $15,505.

    b. $45,055.

    c. $59,905.

    d. $129,905.

18. Under what rule is a partner's share of partnership recourse and nonrecourse liabilities for disguised sale purposes is determined?

    a. IRC Sec. 707.

    b. IRC Sec. 752

    c. IRC Sec. 1272.

    d. IRC Sec. 1274.

19. In accordance with Reg. 1.707-5(a)(4) which of the following statements regarding netting of liabilities is accurate?

    a. Netting is allowed between existing and precontribution liabilities in determining consideration for a disguised sale.

    b. Netting is only allowed on qualified precontribution liabilities that have been transferred to the partnership by more than one partner in accordance with a plan.

    c. Netting is only allowed on nonqualified precontribution liabilities that have been transferred to the partnership by more than one partner pursuant to a plan.

    d. Netting is allowed on both qualified and nonqualified precontribution liabilities that have been transferred to the partnership by at least two partners pursuant to a plan.

20. A transaction is considered a disguised sale if a partner contributes property to a partnership and, subsequent to such contribution, the partnership incurs a liability and ________ days later uses the proceeds to make a distribution to the contributing partner.

    a. 60.

    b. 120.

21. Whether the distribution referred to in question 20, above, is allocable to the proceeds of the liability is determined using the interest-tracing rules of Temp. Reg. 1.163-8T. The distribution is:

    a. Treated as consideration only to the extent the amount distributed exceeds the partner's allocable share of the partnership liability.

    b. Treated as consideration for the full amount distributed regardless of the partner's allocable share of the partnership liability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. A property transfer from a partner to a partnership (or vice versa) that is followed by a cash distribution by the other party to the transaction is considered to be a sale of the property if two conditions are met. Which of the following is one of those two conditions that require application of the disguised sale rules? **(Page 230)**

    a. **The transfer of money or other consideration would not have occurred if the transfer of the property had not occurred. [This answer is correct. If the transfer of money or other consideration resulted from the transfer of property, such action may be classified as a sale of property if one other condition is also met.]**

    b. If the transfers are not simultaneous, the subsequent transfer of money depends on the entrepreneurial risks of partnership operations. [This answer is incorrect. The subsequent transfer of money does *not* depend on the entrepreneurial risks of partnership operations if the transfers are not simultaneous.]

    c. If the transfers are not simultaneous, the subsequent transfer of property depends on the entrepreneurial risks of partnership operations. [This answer is incorrect. If the transfers are not simultaneous, the subsequent transfer of property does *not* depend on the entrepreneurial risks of partnership operations.]

15. Of the following, which one may confirm the existence of a disguised sale? **(Page 230)**

    a. The transferor does not have a legal right to the subsequent transfer. [This answer is incorrect. In order to confirm the existence of a disguised sale, the transferor must have a right to the subsequent transfer that is legally enforceable.]

    b. The partnership has not incurred debt to acquire money/other consideration needed for the transfer. [This answer is incorrect. If the partnership has incurred, or is obligated to incur, debt to acquire money or other consideration necessary to make the transfer possible, such circumstances may confirm the existence of a disguised sale.]

    c. **Control of partnership operations is designed to affect an exchange of the burdens/benefits of property ownership. [This answer is correct. The existence of a disguised sale may be confirmed if partnership allocations, partnership distributions, or control of partnership operations is intended to affect an exchange of the burdens and benefits of property ownership.]**

    d. The transfer of money/other consideration by the partnership to the partner is comparable to the partner's continuing interest in partnership profits. [This answer is incorrect. In order to prove the existence of a disguised sale, the transfer of money/other consideration by the partnership must be disproportionately large in relationship to the partner's general and ongoing interest in partnership profits.]

16. A disguised sale treatment may be avoided as a result of all the following actions **except**: **(Page 234)**

    a. Guaranteed payments reasonable in amount are made to a partner in return for the use of capital. [This answer is incorrect. Guaranteed payments reasonable in amount that are made in return for the use of capital are not considered part of a disguised sale transaction.]

    b. Operating cash flow has been distributed. [This answer is incorrect. A distribution of operating cash flow is a type of payment that is not considered part of a disguised sale transaction.]

    c. **The partner's right to receive the transfer of money is secured in any manner. [This answer is correct. The partner's right to receive the transfer of money or other consideration secured in any manner demonstrates a disguised sale.]**

    d. There has been a reimbursement of preformation expenses. [This answer is incorrect. There are a number of payment types that are not considered part of a disguised sale transaction. One such type of payment is a reimbursement of preformation expenses.]

17. Company XYZ's net cash flow is _________ based on the following information:

    Taxable income: $200,000; Tax-exempt interest: $5,450; Depreciation: $22,200; Amortization: $7,425; Other noncash expenses: $3,380; Principal payments: $60,775; Capital reserves: $80,275; Capital expenditures: $35,000; and other nontaxable cash expenses: $2,500. **(Page 237)**

    a. $15,505. [This answer is incorrect. $15,505 would be the resultant net cash flow if depreciation is incorrectly subtracted rather than added in the net cash flow formula.]

    b. $45,055. [This answer is incorrect. Company XYZ's net cash flow would be $45,055 if the calculation is made by incorrectly subtracting amortization instead of adding those amounts during the calculation process.]

    c. $59,905. [This answer is correct. When the net cash flow formula is properly applied using the above stated amounts, the correct net cash flow for Company XYZ is $59,905.]

    d. $129,905. [This answer is incorrect. If capital expenditures are mistakenly added instead of being subtracted during the calculation process, the net cash flow result would be $129,905.]

18. Under what rule is a partner's share of partnership recourse and nonrecourse liabilities for disguised sale purposes is determined? **(Page 239)**

    a. IRC Sec. 707. [This answer is incorrect. IRC Sec. 707 addresses transactions between partners and partnerships.]

    b. IRC Sec. 752. [This answer is correct. IRC Sec. 752 addresses the treatment of certain liabilities, including both recourse and nonrecourse liabilities.]

    c. IRC Sec. 1272. [This answer is incorrect. IRC Sec. 1272 deals with current inclusion in income of original issue discount.]

    d. IRC Sec. 1274. [This answer is incorrect. IRC Sec. 1274 covers determination of issue price in the case of certain debt instruments issued for property.]

19. In accordance with Reg. 1.707-5(a)(4) which of the following statements regarding netting of liabilities is accurate? **(Page 240)**

    a. Netting is allowed between existing and precontribution liabilities in determining consideration for a disguised sale. [This answer is incorrect. Netting is *not* allowed between existing and precontribution liabilities when determining what is consideration for a disguised sale per the regulations.]

    b. Netting is only allowed on qualified precontribution liabilities that have been transferred to the partnership by more than one partner in accordance with a plan. [This answer is incorrect. Netting is not available exclusively to only qualified precontribution liabilities per the regulations.]

    c. Netting is only allowed on nonqualified precontribution liabilities that have been transferred to the partnership by more than one partner pursuant to a plan. [This answer is incorrect. Netting is not available exclusively to only nonqualified precontribution liabilities per the regulations.]

    d. Netting is allowed on both qualified and nonqualified precontribution liabilities that have been transferred to the partnership by at least two partners pursuant to a plan. [This answer is correct. If qualified or nonqualified precontribution liabilities have been transferred to the partnership by more than one partner pursuant to a plan, netting is allowed for either type of liability per the regulations.]

20. A transaction is considered a disguised sale if a partner contributes property to a partnership and, subsequent to such contribution, the partnership incurs a liability and _______ days later uses the proceeds to make a distribution to the contributing partner. **(Page 248)**

    a. **60. [This answer is correct. If a partner contributes property to a partnership and the partnership subsequently incurs a liability and *within 90 days* uses the proceeds to make a distribution to the contributing partner, the transaction is considered a disguised sale.]**

    b. 120. [This answer is incorrect. Use of the proceeds by the partnership 120 days after incurring a liability to make a distribution to the contributing partner, falls outside the limit for being considered a disguised sale.]

21. Whether the distribution referred to in question 20, above, is allocable to the proceeds of the liability is determined using the interest-tracing rules of Temp. Reg. 1.163-8T. The distribution is: **(Page 248)**

    a. **Treated as consideration only to the extent the amount distributed exceeds the partner's allocable share of the partnership liability. [This answer is correct. The partner's allocable share of the partnership liability is not treated as consideration in the distribution per the regulations.]**

    b. Treated as consideration for the full amount distributed regardless of the partner's allocable share of the partnership liability. [This answer is incorrect. The full amount distributed regardless of the partner's allocable share of the partnership is *not* treated as consideration; but rather only that portion of the amount distributed that exceeds the partner's allocable share of the partnership liability.]

MAKING CONTRIBUTIONS OF PARTNERSHIP DEBT TO THE PARTNERSHIP

Apparently, a partner's contribution of a partnership's own obligation does not result in cancellation of debt income. Such a transfer, however, may cause the contributor's partnership interest to be treated as depreciation recapture property to the extent of the contributed partnership debt. (Any subsequent sale of the partnership interest would produce ordinary income.) The amount of ordinary recapture income is equal to the sum of any bad debt deduction previously taken by the contributor with respect to the contributed debt plus any ordinary loss recognized by the contributor on the transaction. (Because of the nonrecognition rule, no ordinary loss is recognized on the contribution.)

The general rule provides that no gain or loss is recognized on contributions of property to a partnership. However, a question arises as to whether a note from a partnership to the partner constitutes property for purposes of applying the general rule.

Although there is no case law regarding this issue as it relates to partnerships, case law on the parallel corporate provision, IRC Sec. 351, supports the nonrecognition of gain or loss on debt-for-equity transfers. In a 1947 case, the Tax Court held that a nontaxable transfer under IRC Sec. 351 occurred when judgment creditors in a bankruptcy proceeding were issued stock in the debtor corporation. Reg. 1.61-12(a) provides that the gratuitous forgiveness of a corporate debt by a shareholder is a contribution of capital (this apparently does not depend on control immediately after the contribution). Therefore, it would appear that a debt-for-equity contribution in a partnership context would also be respected as a nontaxable transfer.

It is important to note, however, that such nonrecognition treatment does not apply to corporate debt not evidenced by a security. IRC Sec. 351(d) states that stock issued for corporate debt not evidenced by a security is not considered issued for property. In Ltr. Rul. 8117210 the IRS implied it is studying the issue of whether the cancellation of a loan not represented by a written note in exchange for a partnership interest would qualify for nonrecognition treatment. This seems to be a clear indication that if a loan is evidenced by a written note it will qualify for Section 721 nonrecognition treatment.

When considering the contribution of partnership debt to the partnership, the practitioner should consider the impact on the noncontributing partners. A reduction in the amount of partnership liabilities will cause a reduction in the tax basis of each noncontributing partner in his or her partnership interest.

Additionally, if the contributing partner's capital account is credited for an amount that is greater than or less than the amount of the liability being transferred, the contribution may be taxable. When a partner gives up the right to be repaid his or her capital contribution in favor of another partner, and that *transfer* is compensation for services or is in satisfaction of a liability, the general nonrecognition rule does not apply. Where a contributing partner's capital account is credited for an amount less than the face value of the liability transferred, it appears he must recognize gain or loss on the transfer since the contributing partner is not giving up his capital as compensation for services or to satisfy an obligation. However, where the contributing partner's capital account is credited for an amount in excess of the face value of the liability transferred, gain or loss probably will be recognized by both the contributing partner and the partnership. The contributing partner will have income to the extent of the FMV of the excess amount credited to his capital account. The partnership will have an expense or loss equal to the reduction in the noncontributing partners' capital accounts.

Example 1-22: Planning for the contribution of partnership debt to a distressed partnership.

Jim Crockett and Davy Bowie formed Alamo Limited Partners to build and operate the Alamo Apartments. Jim and Davy, the general partners, sold 25 limited partner units to other investors. The construction of the apartments was 100% financed by a local savings and loan. The project has been experiencing high vacancy rates and has not produced enough operating cash flow to fund debt service. Consequently, Jim has advanced $300,000 to the partnership to fund cash flow deficits.

Since there seems to be no chance that the partnership will be able to repay Jim, he has considered converting his $300,000 note to equity in the partnership. This is allowable under the terms of the partnership

agreement. Will the contribution of a partnership note result in the recognition of gain or loss to the contributing partner or the partnership? What are Jim's options regarding the note?

This transaction should qualify for nonrecognition treatment. Had Jim contributed the cash directly to the partnership instead of loaning the money and then converting the loan to equity, there is no doubt that the contribution would have resulted in no gain or loss recognition to the contributing partner or the partnership. Jim's contribution of Alamo Limited Partners' note to the partnership in exchange for equity in the partnership does not give rise to taxable income or loss unless Jim's capital account is credited with an amount in excess of the face value of the debts transferred.

An alternative available to Jim in the preceding example, if he does not want to contribute his receivable to the partnership, is to take a bad debt deduction for the amount of the note. The availability and tax treatment of this deduction hinge on whether the facts and circumstances support a business or nonbusiness bad debt deduction (IRC Sec. 166). Business bad debt deductions result in ordinary losses and are deductible under the taxpayer's method of accounting for bad debts. A nonbusiness bad debt results in a capital loss and is deductible in the year it becomes wholly worthless. A bad debt deduction may be a preferable alternative to Jim depending on the economic outlook for the partnership.

Installment Note

If a partner sells property to a partnership on the installment basis and later contributes the installment receivable to the partnership in exchange for a partnership interest, the nonrecognition rule should apply. However, even though the partner does not recognize gain or loss under the partnership contribution provisions, if all gain on the installment note has not been recognized, the contributing partner will have to report any remaining gain in the year of the contribution. The IRS ruled that in a corporate transfer-for-stock situation, the gain on an installment receivable transferred to a corporation in exchange for stock caused the installment note to "cease to exist," therefore causing an immediate recognition of the deferred profit by the contributor (Rev. Rul. 73-423). It is almost certain that the IRS would apply this same interpretation in the case of a contribution to a partnership.

MAKING PROMISSORY NOTES CONTRIBUTIONS

A partner's contribution of a third party's promissory note generally is treated as a property contribution under the same rules governing other property contributions. While the partner's own promissory note also constitutes property, a partner's contribution of his own promissory note is not treated the same as other property contributions. Generally, the contribution of a partner's own promissory note does not increase that partner's basis in the partnership interest until payments are made on the note. (If the contributor of the note is a limited partner, the note may, however, give rise to a basis increase by increasing the partner's share of partnership recourse liabilities.)

If the partnership holds the note and the partner later makes payments on the note, the payments are treated as delayed capital contributions, increasing the partner's basis in his or her partnership interest (Rev. Rul. 80-235). The partnership recognizes no income from such payments, even though, had the partner contributed another party's promissory note, payments received by the partnership in excess of its basis in the note would constitute taxable gain. (It is not clear when, if ever, imputed interest or original issue discount principles have any application to these deferred capital contributions.) If the partnership subsequently pledges the partner's promissory note as security for a loan, these tax results are not altered. (Such a pledge, however, could create additional basis for the limited partners because of an increase in their share of partnership liabilities.)

The proper treatment of a partnership's sale of partner promissory notes to a third party is not clear. Under normal circumstances, a partnership's sale of zero-basis property causes the partnership to recognize gain. If the partner's note, however, is treated simply as evidence of an open transaction—the partner's obligation to make a deferred capital contribution—a situation clearly contemplated by the Code—gain should not be recognized.

Regulations setting forth capital account maintenance requirements for testing income and loss allocations tend to support an open transaction treatment. Under these regulations, the capital account of a partner who contributes a promissory note is increased only upon payment of the note or upon the partnership's receipt of proceeds from a taxable disposition. This capital account treatment implies that amounts received upon disposition of a partner's

promissory note to a third party are treated as a deemed contribution of the proceeds by the partner. The transaction is treated as if the partner had given the promissory note directly to the third party to evidence a loan and then used the proceeds to make a contribution. This result is more consistent with the reality of the situation than an alternative treatment that would cause the partnership to recognize gain.

Moreover, if the partnership's disposition of the note is treated as a taxable disposition of partnership property, the contributor's capital account is not increased by the entire proceeds of the disposition, but only by the gain attributable to the difference between the note's zero basis and its FMV at the time of contribution. The remaining gain, if any, is allocated among all the partners.

This latter alternative appears to reflect what happens when a partner contributes his or her own note if that note is publicly traded at the time of contribution. In such cases, the partner's capital account is credited immediately with the note's FMV, but the partnership has a zero basis in the note. It is at least possible that a partner contributing the note would recognize gain if the partnership sold the zero-basis promissory note to a third party, even though no gain would be recognized if the contributing partner had issued the note directly to the same third party and contributed the proceeds to the partnership.

One also could argue that gain should not be recognized upon a disposition of the note because the transaction constitutes merely an anticipatory realization of the capital contribution. The partner's later payment of the note remains, in substance, a capital contribution. For example, if a partnership obtained the proceeds of a loan from a bank with individual partners signing notes evidencing the repayment obligation in their individual capacities, neither the partnership nor the partners would recognize gain or loss on the bank's acquisition of the notes. The substance of a transfer of a partner's note evidencing a capital contribution obligation is the same, the only difference being the order in which events occur.

Example 1-23: Determining the tax effects of a partner's contribution of a promissory note.

D.B., a developer, formed Slippery Oaks Limited Partnership to develop and operate an apartment building. Twenty limited partner units were offered to investors. Under the partnership agreement, limited partners make a $5,000 initial contribution upon subscription. An additional $15,000 is due in three annual installments of $5,000 each. The amount of each installment was calculated to match the limited partners' share of partnership losses. Each limited partner must deliver a $15,000 promissory note (not publicly traded) to evidence the deferred capital contribution obligation.

Slippery Oaks has the power to pledge or sell the promissory notes. Because additional cash is needed to operate the building, Slippery Oaks would like to either borrow the needed funds and pledge the notes as security or sell the notes to a third party who has offered to purchase them at a reasonable discount. How will the contributions of promissory notes by the limited partners and the partnership's disposition of those notes be taxed?

Each limited partner acquires a $5,000 basis in his or her interest as a result of the initial $5,000 cash contribution. The limited partners do not acquire basis by reason of their promissory notes until the notes are paid or the partnership transfers or pledges the notes and receives the proceeds from the disposition or pledge.

Until the nontaxable nature of these transactions is confirmed, the practitioner might suggest that Slippery Oaks pledge the limited partner notes as security for a loan, rather than selling them. This reduces the tax risks of the transaction. The practitioner might also suggest that the limited partners directly borrow the money from the bank and contribute the borrowed money to pay off their notes. This avoids the possibility of phantom gain.

A major problem created by the disposition of a partner promissory note by the partnership is how the disposition should be accounted for on the partnership's books. This particularly creates problems in a situation where the partnership agreement provides for the "return of capital" to partners. For example, if Partner A and Partner B contribute identical notes at the same time, and Partner A's note is subsequently transferred to a third party, the capital account of Partner B would be increased by his payments on the note to the partnership, while Partner A's capital account would be increased only by the proceeds received from the third party. The two partners could have

very different capital accounts, even though their "contributions" were identical. When the property is sold, how much "capital" is returned to each partner? It would appear that if each partner contributed $20,000 to the partnership, each partner would expect a $20,000 return of capital regardless of what the partnership did with the promissory notes.

Contributing Installment Obligations

The installment obligation of a third party constitutes property that can be contributed to a partnership subject to the nonrecognition rule. If a partner is recognizing gain from a transaction on the installment basis, the contribution of the installment obligation is not a disposition causing an acceleration of gain recognition unless the partnership itself is the debtor on the obligation. Such contributions, however, cannot easily be used to shift recognition of the deferred gain to other taxpayers. As long as the contributing partner remains a partner, he or she will be specially allocated the gain recognized as the note is collected, to the extent the gain represents the difference between the partner's basis in the obligation and its FMV at the time of contribution.

A contributing partner apparently can avoid recognizing gain on an installment obligation to the extent the gain is entirely capital and the partner disposes of the entire partnership interest through gifts before the gain is recognized. [Unrealized capital gain would not be treated as an unrealized receivable for purposes of IRC Sec. 751(a).] The family partnership rules may be relevant in determining whether such gifts would be recognized for income tax purposes.

ZERO-BASIS RECEIVABLES CONTRIBUTIONS

A partner's contribution of zero-basis receivables, at least to a cash-basis partnership, is treated as a property contribution subject to the same rules as other contributions. However, this treatment is subject to assignment-of-income principles and may depend on whether the transaction has a business purpose and whether tax avoidance motives or possibilities are present.

An account receivable is a contractual right to receive money; as such, it constitutes property. (See Example 1-4.) Since receivables are deemed to be property, the contribution of zero-basis accounts receivable to a partnership is taxed under the general nonrecognition rule applicable to contributions of property, unless there is a significant reason for a different treatment. In fact, Congress has indicated that, when such contributions do not evidence a tax avoidance motive and have a valid business purpose (at least when the contribution is to a cash-basis partnership), the nonrecognition rule applies.

In such circumstances, the partnership assumes the contributor's zero basis in the receivables, and, under generally applicable rules [IRC Sec. 704(c)], the income realized by the partnership from the collection of the receivables is taxed to the contributor to the extent that such income reflects the difference between the receivables' zero basis and their FMV at the time of contribution. (While each receivable is a separate item of property subject to the test, it is believed that it may be appropriate to aggregate them for these calculations.) In the event that collections exceed the FMV of the receivables at the time of contribution, some of this income will be allocated to the other partners.

Contributions of zero-basis receivables are not taxed as contributions in all cases. While it sanctioned some such contributions, Congress clearly indicated that assignment of income principles are still applicable to such transactions. If the contributor was taxed under such principles, he or she would be taxed directly on all income from the receivables as they were collected and then treated as having contributed the cash to the partnership.

In the analogous corporate situation, nonrecognition treatment for a contribution of zero-basis receivables may be conditioned upon a business purpose for the transaction (such as a change in the form of conducting a business), a requirement that payables be transferred along with the receivables, and no other evidence of tax avoidance (such as an accumulation of receivables or prepayment of payables).

In the partnership setting, the requirement that income from property be taxed to the contributor to the extent that it reflects the difference between the property's basis and FMV at the time of the contribution serves to limit tax avoidance possibilities. Nevertheless, in the absence of controlling precedent or regulatory guidance, a prudent

practitioner desiring some level of certainty might suggest that a contribution of zero-basis receivables be made only for valid business reasons, that it be accompanied by an assumption by the partnership of related payables, and that there be no accumulation of receivables or prepayment of payables. [The cash-basis payables are not considered partnership liabilities, and the expenses are deductible by the transferor as they are paid under Section 704(c) principles.]

Although Congress addressed nonrecognition treatment only for contributions of zero-basis receivables contributed by cash-method taxpayers to partnerships using the cash method, it would seem that the same result should apply if the partnership used the accrual basis. In such cases, the collection of the receivables would produce income, as each collection would involve realizing an amount greater than the partnership's basis in the receivable. Nevertheless, the legislative history makes this result less certain than when a cash-method partnership is involved.

Example 1-24: Contributing zero-basis accounts receivable to a cash-basis partnership.

For several years Mason Peary has operated his law practice as a cash method sole proprietorship. He has agreed to bring in Marshall Owen, an employee, as a partner. Peary is concerned whether he should contribute the accounts receivable of his practice to the new partnership, which will also use the cash method. The accounts receivable generally total $60,000 at any given point. Based on Peary's collection history, he could probably sell the receivables to a third party for 95% of their face value, or $57,000, based on the average amount of receivables. How will income from Peary's receivables be taxed if he contributes them to the new partnership?

The practitioner should suggest that Peary contribute his $60,000 of zero-basis accounts receivable, but to avoid assignment-of-income issues, the partnership should also assume the payables of Peary's practice. Peary would still be taxed on the first $57,000 of the income to be realized from the receivables, which represents the amount by which their FMV exceeds their zero basis on the contribution date.

If, instead of a law practice, Peary, in the preceding example, had operated a business with a working capital loan secured by receivables, contributing the zero-basis receivables subject to the loan could create problems. Unlike cash-method payables, the working capital loan constitutes a liability. The partnership's assumption of this liability results in a deemed cash distribution to Peary. (See Example 1-7.) Depending on a number of factors, this deemed distribution could produce taxable gain to Peary in addition to the income that would be taxed to him from the collection of the receivables. In this situation, Peary may be better off retaining both the receivables and the loan and paying off the loan as the receivables are collected, or perhaps selling the receivables to the partnership and using the proceeds to pay the loan.

APPRECIATED OR DEPRECIATED PROPERTY CONTRIBUTIONS

In many cases, property contributed to a partnership has a FMV that is different from its basis. The contribution of such appreciated or depreciated property does not trigger the recognition of gain or loss. However, depreciation, depletion, and the gain or loss on sale of such contributed property must be allocated among the partners in a manner that takes into account the difference between basis and FMV on the contribution date. In other words, gain inherent in the contributed property must be allocable to the contributing partner, and depreciation or depletion deductions relating to the difference between the FMV and basis of the contributed property (on the contribution date) must also be allocated in a manner that reduces as quickly as possible the book/tax difference created by the contribution.

If built-in loss property is contributed to a partnership (a) the built-in loss is taken into account only in determining the amount of items allocated to the contributing partner; and (b) except as provided in regulations, in determining the amount of items allocated to the other partners, the basis of the contributed property in the hands of the partnership is treated as being equal to the fair market value (FMV) of the property at the time of contribution. This prevents a partner contributing built-in loss property from transferring the loss to another person by transferring his partnership interest. When the partnership interest is transferred, the built-in loss is eliminated. Built-in loss is the excess of the adjusted basis of the property over its FMV at the time of contribution.

An installment obligation received from the disposition of Section 704(c) property will be treated as the Section 704(c) property. If a partner contributes a contract that is Section 704(c) property to the partnership and the

partnership later acquires property pursuant to that contract in the transaction in which less than all of the gain or loss is recognized, the acquired property is treated as the Section 704(c) property for Sections 704(c) and 737 purposes. Regs. 1.704-4(d)(1) and 1.737-2(d)(3) state that, if an installment obligation received by a partnership or property acquired pursuant to a contributed contract is distributed to a partner other than the contributing partner within seven years of the contribution, the contributing partner may recognize gain or loss under IRC Sec. 704(c)(1)(B).

Distributions of Contributed Property

IRC Sec. 704(c)(1)(B) provides that when property contributed by one partner is distributed to another partner within seven years of a contribution, any precontribution gain or loss must be recognized by the contributing partner. Although a partner does not recognize gain or loss on the contribution of appreciated or depreciated property, any precontribution gain or loss must be recognized by the contributing partner upon distribution of the property to another partner within a seven-year period.

IRC Sec. 731(c) changed the taxation of marketable security distributions. Under this rule, when determining (a) whether gain or loss is recognized on a distribution to a partner and (b) the recognition of precontribution gain in the case of distributions to contributing partners under IRC Sec. 737, distributions of marketable securities are treated as distributions of money in an amount equal to the FMV of the securities on the distribution date. As a consequence, a distributee recognizes gain to the extent the FMV of the securities then exceeds the distributee's basis in his or her partnership interest.

Character of Gains and Losses on Dispositions of Contributed Property

The character of the gain or loss recognized by a partnership on the disposition of contributed unrealized receivables, inventory, and capital loss property is governed by IRC Sec. 724. These rules prevent taxpayers from changing the character of gain recognized on the sale of property by contributing the property to a partnership.

Contributed unrealized receivables generate ordinary income when they are disposed of by the partnership. Unrealized receivables include recapture property covered by IRC Secs. 197(f)(7), 460, 467(c), 617(f)(2), 992, 1245, 1248, 1250, 1252, 1253, 1254, 1255, 1257(d), 1278, and 1283.

The preferential capital gains rate makes an important distinction in the characterization of gains and losses as capital or ordinary. The distinction remains doubly important to individuals with capital losses because these losses generally provide a tax benefit only to the extent they can be used to offset capital gains. [Noncorporate taxpayers are, however, allowed to deduct $3,000 of capital loss per year (IRC Sec. 1211).] In the partnership setting, the character of income upon a sale of assets is also important in applying the "collapsible partnership" rules, which can sometimes cause unexpected results when income is recognized on a transfer or change in interest.

Because a contributing partner and the partnership are separate and distinct taxpayers, property that is a capital asset in the hands of the contributor may become trade or business property or inventory in the hands of the partnership, and vice versa. This issue is discussed in Example 1-25. Two provisions of the Code limit the ability of a partner and partnership to manipulate the character of gain or loss on property that was inventory or capital loss property in the hands of the contributor. The rules generally provide that such property retains the same character it had in the hands of the contributor for five years after the contribution date. These rules are discussed in Examples 1-26 and 1-27.

If contributed property was an inventory item in the hands of a partner immediately before its contribution, it retains a special status in the partnership's hands. As a result, any gain or loss realized by the partnership on the disposition of the property during the five-year period immediately following the contribution is taxed as ordinary income or loss. For this purpose, inventory items include stock in trade, property held for sale to customers in the ordinary course of business, and any other property that is not a capital asset or Section 1231 property.

If property contributed to a partnership was a capital asset in the hands of the contributor immediately prior to the contribution, any loss recognized on the disposition of the property within five years is treated as a capital loss to the extent that the contributor would have recognized a capital loss had the property been sold for its FMV at the time of contribution.

Example 1-25: Anticipating a recharacterization of contributed property.

Harv and Yale, unrelated persons, formed a 50/50 partnership, Ivy Developers, to subdivide and sell Marbleacre, a property owned by Harv. Harv is not engaged in the real estate business. He contributed Marbleacre, which he had owned for five years. At that time, Marbleacre had a $300,000 FMV and an $80,000 basis. Yale, a real estate developer, contributed $300,000 cash. Ivy Developers later subdivided the land and sold the lots to homeowners. It recognized a $700,000 tax gain on the sale of the subdivided lots.

The characterization of partnership property as a capital asset, Section 1231 property, inventory, or other property is based on its use by the partnership. In Harv's hands, Marbleacre was a capital asset. Its sale would have produced capital gain. In the hands of Ivy Developers, however, Marbleacre became property held for sale to customers in the ordinary course of the partnership's business. Consequently, the $700,000 gain recognized by Ivy Developers on the sale of the Marbleacre parcels was ordinary income. Of this ordinary income, $220,000 was allocated to Harv to reflect precontribution appreciation. The remaining $480,000 was divided equally between Harv and Yale. As a result, Harv recognized ordinary income of $460,000.

The transaction in the preceding example could have been structured to reduce Harv's ordinary income by Harv selling the land to Ivy Developers at its FMV, rather than contributing it. So long as Harv did not then have an interest of more than 50% in Ivy Developers' capital or profits, he would have recognized the $220,000 as capital gain, rather than the ordinary income he ultimately recognized because of the partnership's sale of the property. [Under IRC Sec. 707(b)(2), gain recognized by a partner on a sale or exchange of property to a partnership in which the partner owns more than a 50% capital or profits interest will be ordinary income if the transferred property is not a capital asset in the hands of the partnership.] (Alternatively, Harv could have sold the land to Yale, after which they could have formed the partnership, with Yale contributing the land and Harv contributing the cash.) The desirability of doing this would depend on the relative tax rates applicable to Harv's capital gains and ordinary income, as well as the time value of money considerations related to when the gain will be reported and the tax paid. The desired structure of the transaction also could be affected by whether Harv had capital losses from other sources that could be netted against capital gain but not ordinary income. Additionally, they might have been able to structure a sale of Marbleacre to Ivy Developers so that Harv's initial gain could be reported on the installment method.

In certain circumstances, a practitioner may be able to help structure a transaction to cause a desirable recharacterization of future income from ordinary income to capital gain. However, while the character of contributed property is determined at the partnership level, that determination is based on the facts and circumstances of each situation. The practitioner should also ensure that the partnership operates as a separate and independent entity and not merely as an extension or agent of the contributing partner's business or as an alter ego of the contributing partner.

Example 1-26: Avoiding ordinary income on disposition of a capital asset that was ordinary income property in the hands of a contributor.

John, Paul, and George are members of a small investment partnership, Ringo Co., which holds a variety of investment assets. In 2010, the partners each agreed to contribute an additional $5,000. Without seeking the advice of a tax practitioner, the partners permitted George, a dealer in jewelry, coins, and precious metals, to contribute gold coins in lieu of cash. George had acquired the coins for $3,500 several months earlier in the course of his business. The FMV of the coins at the time of contribution was $5,000. In 2011, Ringo Co. sold the coins for $7,000. Does Ringo Co. recognize ordinary income or capital gain on its sale of the coins contributed by George?

The gold coins contributed by George were inventory in his hands immediately prior to the contribution. Consequently, even though Ringo Co. was not a dealer in gold coins but held the coins for investment, its gain or loss on any disposition of the coins within five years of the date of George's contribution is determined as if Ringo Co. were a dealer in the property. As a result, its entire $3,500 gain on the year 2011 sale constituted ordinary income. (Note that $1,500 of the gain would be allocated to George to account for precontribution appreciation.)

Example 1-27: Determining the tax effects of a partnership's disposition of contributed capital loss property.

Kenny is a partner in Adam Smith Traders, a partnership that conducts an active securities trading business. On March 1, 2010, in lieu of a $10,000 cash capital contribution, Kenny contributed IBU Co. stock with a $10,000 FMV. Kenny acquired the stock two years earlier as a personal investment. His basis in the contributed stock was $13,000. On April 1, 2011, Adam Smith Traders sold the IBU stock for $9,000, recognizing a $4,000 loss. What is the character of the loss recognized by Adam Smith Traders on the sale of the IBU stock contributed by Kenny?

Adam Smith Traders is engaged in an active securities trading business and normally recognizes ordinary income or loss on its sale of securities held as trade or business assets. However, because (1) the IBU stock was a capital asset in Kenny's hands at the time of contribution and (2) Kenny would have recognized a $3,000 capital loss had he sold the stock for its FMV at that time, the first $3,000 of any loss recognized by Adam Smith Traders prior to March 1, 2015, will be a capital loss. Consequently, upon the company's April 1, 2011, sale of stock, $3,000 of its $4,000 loss must be treated as a capital loss. (As long as Kenny is a partner at the time the loss is recognized, the capital loss is allocated entirely to Kenny.) The remainder of the loss ($1,000) is treated as an ordinary loss.

LONG-TERM CONTRACTS CONTRIBUTIONS

Regulations address contributions of contracts accounted for under a long-term contract method to a partnership. They generally provide that a partner that contributes a contract accounted for under a long-term contract method must increase the basis of his or her partnership interest by the amount of gross receipts that the partner has recognized under the contract and reduce the basis of the interest by the amount of gross receipts the partner has received or reasonably expects to receive under the contract. If the decrease exceeds the partner's basis in the interest, income equal to the amount of the excess must be recognized. The partnership then reduces its total contract price (or gross contract price) by the amount of income recognized by the contributing partner.

The regulations also provide that the principles of IRC Sec. 704(c) apply to allocations of income or loss with respect to a contract accounted for under a long-term contract method that is contributed to a partnership (or that is revalued by a partnership under the Section 704 rules). The regulations provide rules for determining the built-in gain or loss attributable to a contributed contract that is subject to IRC Sec. 704(c). Under these rules, (a) the contributing partner must take into account any income or loss required under the step-in-the-shoes rules for the period ending on the date of the contribution; (b) the partnership must then determine the amount of income or loss that the contributing partner would take into account if the contract were disposed of for its FMV in a constructive completion transaction (this calculation is deemed to occur immediately after the partner has applied the step-in-the-shoes rules, but before the contribution to the partnership); and (c) the amount determined in step (b), reduced by the amount the contributing partner is required to recognize in step (a), is the built-in gain or loss.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Which of the following accurately describes the results of contributing partnership debt to the partnership?

    a. When a partner relinquishes the right to be repaid his or her capital contribution in favor of another partner in certain circumstances (for services or a liability), the general nonrecognition rule does not apply.

    b. A contributing partner is not required to recognize gain or loss on a transfer when his or her capital account is credited for an amount less than the face value of the liability transferred.

    c. When the contributing partner's capital account is credited for an amount greater than the face value of the liability transferred, gain or loss is only recognized by the contributing partner.

    d. Considering the impact on the noncontributing partners is not necessary when considering the contribution of partnership debt to the partnership.

23. The results of contributing promissory notes to a partnership are accurately described by which of the following?

    a. A partner's contribution of a third party's promissory note generally is not treated as a property contribution under the same rules governing other property contributions.

    b. A partner's contribution of his or her own promissory note generally is treated the same as other property contributions.

    c. The partner's basis in his or her partnership interest is increased if the partnership holds the note and, at a later time, the partner makes payments on the note.

    d. When a partnership sells a partner's promissory notes to a third party, the partnership always recognizes gain.

24. For several years Bill Smith has operated his law practice as a cash method sole proprietorship. Recently he has agreed to bring in James Singletary, an employee, as a partner. Smith is concerned whether he should contribute the accounts receivable of his practice to the new partnership, which will also use the cash method. The accounts receivable generally total $80,000 at any given point in time. Based on Smith's collection history, he could probably sell the receivables to a third party for 90% of their face value, or $72,000, based on the average amount of receivables. The practitioner suggests that Smith contribute his $80,000 of zero-basis accounts receivable, but to avoid assignment-of-income issues, the partnership should also assume the payables of Smith's practice. If Smith follows the practitioner's advice, Smith would:

    a. Defer his tax liability on the $80,000 of zero-basis accounts receivable assets until the make-up of the partnership changes.

    b. Be taxed on his $80,000 of zero-basis accounts receivable assets regardless of whether those assets are contributed or not.

    c. Be taxed on the first $72,000 of the income to be realized from the receivables.

25. The ability of a partner and partnership to manipulate the character of gain or loss on property that was inventory or capital loss property in the hands of the contributor is limited by the Code. The Code rules generally stipulate that such property retains the same character it had in the hands of the contributor for ________ after the contribution date.

    a. Three years.

    b. Five years.

    c. Seven years.

26. Tom, Greg, and Howard are members of a small investment partnership, TGH Co., which holds a variety of investment assets. In 2010, the partners each agreed to contribute an additional $10,000. Without seeking the advice of a tax practitioner, the partners permitted Howard, a dealer in coins, to contribute gold coins in lieu of cash. Howard had acquired the coins for $7,000 several months earlier in the course of his business. The FMV of the coins at the time of contribution was $10,000. In 2011, TGH Co. sold the coins for $14,000. How much gain on the year 2011 sale constituted ordinary income for TGH Co.?

    a. $3,000.

    b. $7,000.

    c. $10,000.

    d. $14,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. Which of the following accurately describes the results of contributing partnership debt to the partnership? **(Page 248)**

    a. When a partner relinquishes the right to be repaid his or her capital contribution in favor of another partner in certain circumstances (for services or a liability), the general nonrecognition rule does not apply. [This answer is correct. When a partner relinquishes the right to be repaid his or her capital contribution in favor of another partner, and that transfer is compensation for services or is to satisfy a liability, the general nonrecognition rule does *not* apply per the regulations.]

    b. A contributing partner is not required to recognize gain or loss on a transfer when his or her capital account is credited for an amount less than the face value of the liability transferred. [This answer is incorrect. A contributing partner generally must recognize gain or loss on the transfer when his or her capital account is credited for an amount in excess of the face value of the liability transferred. This is true due to the fact that the contributing partner is not giving up his or her capital as compensation for services or to satisfy an obligation.]

    c. When the contributing partner's capital account is credited for an amount greater than the face value of the liability transferred, gain or loss is only recognized by the contributing partner. [This answer is incorrect. Gain or loss will likely be recognized by both the contributing partner and the partnership when the contributing partner's capital account is credited for an amount in excess of the face value of the liability transferred.]

    d. Considering the impact on the noncontributing partners is not necessary when considering the contribution of partnership debt to the partnership. [This answer is incorrect. A reduction in the dollar amount of partnership liabilities will cause a reduction in the tax basis of each noncontributing partner in his or her partnership interest; therefore, when considering the contribution of partnership debt to the partnership, the tax consultant should always consider the impact on the noncontributing partners.]

23. The results of contributing promissory notes to a partnership are accurately described by which of the following? **(Page 249)**

    a. A partner's contribution of a third party's promissory note generally is not treated as a property contribution under the same rules governing other property contributions. [This answer is incorrect. A partner's contribution of a third party's promissory note generally *is* treated as a property contribution under the same rules that deal with other property contributions. The third party's promissory note is an asset of the partner and would return the same character once contributed to the partnership.]

    b. A partner's contribution of his or her own promissory note generally is treated the same as other property contributions. [This answer is incorrect. A partner's contribution of his or her own promissory note is not treated the same as other property contributions since such contribution does not increase that partner's basis in the partnership interest until such time as payments are made on the note.]

    c. The partner's basis in his or her partnership interest is increased if the partnership holds the note and, at a later time, the partner makes payments on the note. [This answer is correct. If the partner makes payments on a note held by the partnership, the payments are treated as delayed capital contributions, thus increasing the partner's basis in his or her partnership interest per Rev. Rul. 80-235.]

    d. When a partnership sells a partner's promissory notes to a third party, the partnership always recognizes gain. [This answer is incorrect. A partnership does not always recognize gain when a partner's promissory notes are sold to a third party. Gain should not be recognized if the partner's note is treated simply as evidence of an open transaction, the partner's obligation to make a deferred capital contribution.]

24. For several years Bill Smith has operated his law practice as a cash method sole proprietorship. Recently he has agreed to bring in James Singletary, an employee, as a partner. Smith is concerned whether he should contribute the accounts receivable of his practice to the new partnership, which will also use the cash method. The accounts receivable generally total $80,000 at any given point in time. Based on Smith's collection history, he could probably sell the receivables to a third party for 90% of their face value, or $72,000, based on the average amount of receivables. The practitioner suggests that Smith contribute his $80,000 of zero-basis accounts receivable, but to avoid assignment-of-income issues, the partnership should also assume the payables of Smith's practice. If Smith follows the practitioner's advice, Smith would: **(Page 252)**

    a. Defer his tax liability on the $80,000 of zero-basis accounts receivable assets until the make-up of the partnership changes. [This answer is incorrect. The make-up of the partnership has no bearing on what amount of Bill Smith's zero-basis accounts receivable is to be taxed.]

    b. Be taxed on his $80,000 of zero-basis accounts receivable assets regardless of whether those assets are contributed or not. [This answer is incorrect. Bill Smith would not be taxed on the full $80,000 of the income to be realized from the receivables.]

    c. Be taxed on the first $72,000 of the income to be realized from the receivables. [This answer is correct. Bill Smith would be taxed on the first $72,000 of the income to be realized from the receivables and represents the amount by which the receivables FMV exceeds their zero-basis on the contribution date.]

25. The ability of a partner and partnership to manipulate the character of gain or loss on property that was inventory or capital loss property in the hands of the contributor is limited by the Code. The Code rules generally stipulate that such property retains the same character it had in the hands of the contributor for ________ after the contribution date. **(Page 253)**

    a. Three years. [This answer is incorrect. Property that was inventory or capital loss property retains the same character it had in the hands of the contributor for a period greater than three years.]

    b. Five years. [This answer is correct. The rules generally stipulate property that was inventory or capital loss property retains the same character it had in the hands of the contributor for five years after the contribution date.]

    c. Seven years. [This answer is incorrect. Property that was inventory or capital loss property retains the same character it had in the hands of the contributor for a period less than seven years.]

26. Tom, Greg, and Howard are members of a small investment partnership, TGH Co., which holds a variety of investment assets. In 2010, the partners each agreed to contribute an additional $10,000. Without seeking the advice of a tax practitioner, the partners permitted Howard, a dealer in coins, to contribute gold coins in lieu of cash. Howard had acquired the coins for $7,000 several months earlier in the course of his business. The FMV of the coins at the time of contribution was $10,000. In 2011, TGH Co. sold the coins for $14,000. How much gain on the year 2011 sale constituted ordinary income for TGH Co.? **(Page 254)**

    a. $3,000. [This answer is incorrect. $3,000 of the gain would be allocated to Howard to account for precontribution appreciation.]

    b. $7,000. [This answer is correct. The entire $7,000 gain realized on the year 2011 sale by TGH constituted ordinary income.]

    c. $10,000. [This answer is incorrect. $10,000 was the FMV of the coins at the time of contribution.]

    d. $14,000. [This answer is incorrect. $14,000 was the selling price for the coins in 2011.]

RECOGNIZING DEPRECIATION AND DEPRECIATION RECAPTURE

Depreciation recapture generally is not recognized upon a contribution to a partnership. When a partner contributes depreciated property to a partnership in a nonrecognition transaction, the recapture provisions apply only to the extent gain is required to be recognized on the property transfer under a Code provision other than those governing depreciation recapture (i.e., any gain recognized on the contribution of encumbered property).

By contributing equipment, a partner may only be deferring his or her recapture of depreciation since potential recapture on the equipment carries over to the partnership. A partner's share of Section 1245 gain equals the lesser of (a) the partner's share of total gain from the disposition of the property (the gain limitation) or (b) the partner's share of depreciation or amortization on the property. Any Section 1245 gain recognized by the partnership that is not allocated to a partner because of the gain limitation is allocated proportionately to the partners whose allocable gain from the disposition of the property exceeds their share of depreciation on the property.

The provision that a contribution of personal property to a partnership does not trigger depreciation recapture parallels the provisions for recapture of depreciation on real property, mining exploration expenditures, soil and water conservation expenses, and intangible drilling and development costs.

The IRS has taken the position that gain recognized when property subject to liabilities is contributed to a partnership may be taxed as depreciation recapture. If both recapture and nonrecapture property is contributed, and gain is recognized because of relief from liabilities, the "amount realized" apparently must be allocated among all contributed assets based on their FMVs. This is true even if the liability relates solely to the recapture property. In such cases, only a portion of the gain would be allocable to the recapture property and treated as recapture income. It is believed that the treatment required by the regulations is inconsistent with the fact that the gain results from a constructive cash distribution in excess of the contributor's basis. In such cases, the Code treats any recognized gain as gain from the transfer of a partnership interest, not from the transfer of the contributed property. (See Example 1-8.) Even then, any such basis increase is spread among all appreciated capital assets and Section 1231 property, not just the contributed property.

The only tax benefit the regulations permit as the result of recapture recognized on the contribution of encumbered property is that the partnership reduces its recomputed basis in the property by the gain recognized. This concession provides no benefit if the real value of the property has actually declined.

Example 1-28: Accounting for depreciation and depreciation recapture on the contribution of property to a partnership.

Gordie and Howie are forming ABC Partnership, a 50/50 general partnership, to operate a small contracting business. Gordie contributes $40,000 cash. Howie contributes equipment with a $40,000 FMV that he acquired four years earlier for $40,000. Howie has been depreciating the equipment using straight-line MACRS over a five-year period. The equipment has a $12,000 adjusted basis and is not subject to any liabilities. The partnership will use the traditional method for allocating built-in gain on the contributed property. Any tax gain from the sale of the property will be allocated to Howie first to offset the effect of the ceiling rule limitation.

If Howie sells the contributed equipment to ABC for its $40,000 FMV, he would recognize a $28,000 gain, which would be treated as ordinary income from recapture of depreciation/MACRS deductions (IRC Sec. 1245).

Howie will recognize no gain on the contribution and, consequently, will have no recapture income. Howie's basis in his partnership interest will be $12,000, and ABC will have a $12,000 basis in the equipment. The partnership steps into Howie's shoes and continues to claim cost recovery deductions according to the same schedule Howie used prior to the contribution.

If ABC sells the equipment three years later for $40,000 when it was fully depreciated, the entire gain will be recaptured as ordinary income under IRC Sec. 1245. Since the traditional method was used to allocate the built-in gain, any depreciation calculated after the property was contributed to the partnership was allocated to Gordie, the noncontributing partner.

Howie, who contributed the equipment after he had depreciated it for four years, was allocated depreciation of $28,000, the accumulated depreciation on the equipment at the time he contributed it. Howie is allocated $28,000 of gain from the disposition of the equipment; therefore, his Section 1245 recapture is the gain he recognized—$28,000.

Gordie was allocated all $12,000 of the equipment's tax depreciation while it was held by the partnership (under the traditional method). His tax gain from the property sale is $12,000, all of which is recaptured under IRC Sec. 1245 as ordinary income.

Example 1-29: Accounting for depreciation and depreciation recapture on the contribution of property subject to liabilities to a partnership.

Assume the same facts as in the preceding example, but this time Gordie contributed $10,000 instead of $40,000, and Howie contributed the equipment subject to a $30,000 liability. Howie recognizes a $3,000 gain—the amount by which the $15,000 constructive cash distribution to him attributable to relief from debt exceeds the $12,000 basis in his partnership interest. (See Example 1-8.) Howie must recognize this income as depreciation recapture.

The gain recognized by Howie does not increase the basis in his partnership interest and will not increase the partnership's basis in the contributed property absent a special election.

Howie's original cost for the equipment is deemed to be $37,000 for determining any subsequent recapture, an adjustment that benefits the partnership only if it subsequently sells the equipment for more than $37,000. Assuming no Section 754 election is in effect, a sale of the equipment later in the same year for its $40,000 FMV would cause ABC to recognize a $28,000 gain, $25,000 of which would be depreciation recapture and allocated to the partners in accordance with Reg. 1.1245-1(e)(2).

NONCOMPENSATORY OPTIONS TAXATION FOR PARTNERSHIP INTERESTS

The IRS has issued proposed regulations regarding the exercise of options to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a preferred interest in a partnership for a common interest in that partnership. These proposed regulations do not deal with options issued in connection with the performance of services. They will apply to noncompensatory options that are issued on or after the date final regulations are published in the Federal Register.

In general, the issuance of a partnership interest to the holder of a noncompensatory option should not be taxable to the holder or the partnership. Upon exercise, the option holder is viewed as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest. This is a transaction to which IRC Sec. 721 should apply. Accordingly, the proposed regulations generally provide that IRC Sec. 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership.

If an option lapses, the former option holder does not contribute property to the partnership in exchange for an interest in the partnership. Consistent with general tax principles, the lapse of the option generally results in income recognition by the partnership and loss recognition by the former option holder.

Upon the exercise of a noncompensatory option, the option holder usually receives a partnership interest with a value that is greater or less than the aggregate value of the premium and exercise price that the option holder contributes to the partnership. In other words, the option privilege represents an asset with built-in gain or loss [i.e., an asset to which IRC Sec. 704(c) would apply]. However, because the option privilege terminates upon its contribution to the partnership, the partnership cannot allocate gain or loss from the option privilege to the option holder under IRC Sec. 704(c)(1)(A). To address this problem, the proposed regulations generally allow partnerships to substitute built-in gain or loss in the partnership's assets for the built-in gain or loss in the option.

A noncompensatory option holder's initial capital account is equal to the consideration paid to the partnership to acquire the option plus the FMV of any property (other than the option) contributed to the partnership on the

exercise of the option. The partnership is required to revalue its property immediately after the exercise of the option, when the holder becomes a partner. The partnership allocates the unrealized income, gain, loss, and deduction from this revaluation, first, to the option holder, to the extent necessary to reflect the holder's right to share in partnership capital under the partnership agreement and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of such property for its FMV on that date. To the extent that unrealized appreciation or depreciation in the partnership's assets has been allocated to the capital account of the option holder, the holder will, under IRC Sec. 704(c), recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized.

In some situations, the built-in gain or loss in the option will exceed the unrealized appreciation or depreciation in the partnership's assets (that has not been reflected in the partners' capital accounts previously). In those situations, even after all of the unrealized appreciation or depreciation in the partnership's assets has been allocated to the option holder, a disparity may remain between the option holder's right to share in partnership capital and the value of money and other property contributed by the partner.

The proposed regulations require that the partnership make corrective allocations of gross income or loss to the partners in the year in which the option is exercised to take into account any shift in the partners' capital accounts that occurs as a result of the exercise of the option. These corrective allocations are allocations of tax items that differ from the partnership's allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership's tax allocations to the capital shift, additional corrective allocations are required in succeeding tax years until the capital shift has been fully taken into account.

The proposed regulations also provide rules for revaluing the partners' capital accounts while a noncompensatory option is outstanding. Reg. 1.704-1(b)(2)(iv) contains rules for maintaining a partnership's capital accounts. Reg. 1.704-1(b)(2)(iv)(f) provides that a partnership may, upon the occurrence of certain events (including the contribution of money to the partnership by a new or existing partner), increase or decrease the partners' capital accounts to reflect a revaluation of partnership property. If one or more options are outstanding when a revaluation occurs, and the revaluation does not account for the value associated with the outstanding options, the partners' capital accounts will not reflect the true economic value of their interests. For example, in partnerships with appreciated property, the historic partners' capital accounts may overstate the distributions that would be made to the partners if the partnership were liquidated, because a portion of the partnership's assets may ultimately be paid to the option holder. Therefore, the proposed regulations modify Reg. 1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the FMV, if any, of outstanding options.

Characterization of Noncompensatory Option Holders

Prop. Reg. 1.761-3(a) characterizes the holder of a noncompensatory option as a partner if the option holder's rights are substantially similar to the rights afforded to a partner. This rule applies only if, as of the date that the option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities.

A facts and circumstances test is used to determine whether a noncompensatory option holder's rights are substantially similar to the rights afforded to a partner, including whether the option is reasonably certain to be exercised and whether the option holder has partner attributes. The proposed regulations list a number of factors that are used to determine whether a noncompensatory option is reasonably certain to be exercised, including: the premium paid for the option, the exercise price of the option, the term of the option, the predictability and stability of the value of the underlying partnership interest, and whether the partnership is expected to make distributions during the term of the option. If a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily has rights that are substantially similar to the rights afforded to a partner. Partner attributes include the extent to which the option holder shares in the economic benefit and detriment of partnership income and loss, and the extent to which the option holder has the right to participate in the management of the partnership.

If the option holder is treated as a partner, then the holder's distributive share of the partnership's income, gain, loss, deduction, or credit generally must be determined in accordance with such partner's interest in the partnership under Reg. 1.704-1(b)(3). For this purpose, the partner's interest in the partnership generally must reflect the economic differences between holding an option to acquire a partnership interest and holding the partnership interest itself. For example, unlike a partner, a noncompensatory option holder is not required initially to contribute the full amount of the purchase price for the partnership interest. Instead, the option holder generally pays a premium that is considerably smaller than the purchase price and may wait until the option is about to expire to decide whether to exercise the option and pay the exercise price. The computation of the option holder's share of partnership items should reflect this lesser amount of capital investment to the extent appropriate in a particular case. In addition, an option holder's cumulative distributive share of partnership losses and deductions may be limited under IRC Sec. 704(b) and (d) to the amount paid for the option.

OID Issues Related to Noncompensatory Partnership Options

The proposed regulations will amend the OID provisions to treat partnership interests as stock for purposes of the special rules for convertible debt instruments. See Prop. Regs. 1.1272-1(e), 1.1273-2(j), and 1.1275-4(a)(4).

ADDRESSING APPROPRIATE ASSET CONTRIBUTIONS TO A PARTNERSHIP

The business purpose rule of IRC Sec. 7701(a)(2) requires that partnerships be established for a valid business, investment, or income-producing purpose, and not merely for personal reasons. (As a practical matter, this issue most often arises with family partnerships, which are referred to throughout this lesson.) The types of assets transferred to the partnership will usually indicate whether the partnership has a valid business purpose. As noted in the following paragraphs, personal assets with little or no business or investment purpose should not be transferred to a partnership, even if the partnership owns business assets. On the other hand, assets that are clearly held for business or investment purposes are suitable for placement in a partnership.

Marketable Securities

Investment assets, such as stocks, bonds, and mutual funds are generally good assets for funding family partnerships. Holding such assets in a family partnership allows centralized management (by the general partners) over the investments, and gives the parents the opportunity to impart their investment philosophies with their children while maintaining control over the assets. Clients may be attracted by the opportunity to share in investment activities with their children without giving the children unrestricted control and stifling their ambition. In addition, by maintaining the securities in a larger pool instead of dividing ownership among a number of children and possibly their spouses, investment advisory fees and brokers commissions can be minimized. Also, such assets are easily transferable to the partnership, although care should be taken to ensure that new stock certificates are issued.

Professional advisors have recommended that clients fund partnerships solely with marketable securities, primarily to obtain valuation discounts for gift tax purposes. Understandably, the IRS is quite concerned about this technique, and would like to curtail its use. In a case like this, the client should carefully document the nontax reasons for the partnership's existence, preferably in the partnership agreement, as well as in correspondence between the partners.

Generally, if more than 80% of the partnership's assets are held for investment and are in the form of stocks and securities (defined to include money, foreign currency, futures contracts, and derivatives), mutual fund shares, and REIT units, the partnership may be classified as an investment company under IRC Sec. 721(b). Whereas the contribution of assets to a partnership is usually a nontaxable event, if the partnership is treated as an investment company, the contribution of investment property is treated as a sale by the contributing partner, resulting in gain recognition.

The investment company rules apply only if the capitalization of the partnership results in a diversification of the assets owned by the partners. An example of this would be when two partners both contribute publicly traded stock, resulting in a more diversified portfolio for each partner. This may not be an issue for family partnerships where all property is effectively contributed by one partner with subsequent gifts of limited partner interests to family members, because no diversification is achieved.

Before contributing marketable securities to a partnership, clients should be advised of the tax implications of subsequent distributions. For example, IRC Sec. 731 requires a partner to recognize gain on a partnership distribution if cash or the value of marketable securities distributed exceeds the partner's adjusted basis in his partnership interest immediately before the distribution. In addition, IRC Sec. 737 may cause gain to be recognized when a partner contributed appreciated securities and within seven years receives a distribution of other property. IRC Sec. 704(c) could require precontribution gain related to a marketable security to be allocated to the contributing partner upon any subsequent distribution of the asset to another partner.

Real Estate

Real property, including mineral interests but not the client's personal residence, ordinarily is appropriate for funding a family partnership. However, the client should evaluate any risk, such as environmental risk or the risk associated with oil and gas working interests, when funding a partnership. Liabilities arising from holding such property could place other partnership assets, as well as the general partner's assets held outside the partnership, at risk. The client may be able to overcome such risk with adequate insurance. If the real estate is encumbered (i.e., subject to a mortgage), special rules may apply.

The presence of an acceleration clause in a mortgage note may cause the mortgage to become immediately due and payable and may trigger the cancellation of the title policy when the real estate is transferred to the partnership. However, such restrictions can often be restructured with the lender prior to funding the partnership.

Closely Held Stock

Closely held corporations are appropriate for partnership ownership because they generally are associated with the types of risk that partnerships can shield and they, by definition, meet the business purpose test. But before contributing stock, practitioners should consider the implications of IRC Sec. 2036(b), which provides that the retention of voting rights, directly or indirectly, over the stock of a controlled corporation will cause gross estate inclusion of the stock. For this purpose, a corporation is controlled if, at any time after the transfer of the property and during the three years prior to the transferor's death, the transferor owned (taking into account attribution under IRC Sec. 318) or possessed (alone or with any other person), the right to vote stock possessing 20% or more of the combined voting power of all classes of stock of the corporation.

There is no definitive answer to the question of whether a general partner's ability to vote controlled corporate stock owned by the partnership is an indirect right to vote the stock under IRC Sec. 2036(b). Prop. Reg. 20.2036-2(c) indicates that the capacity in which the transferor can vote the stock is irrelevant, and can be pursuant to an agreement, which presumably can include a partnership agreement. In TAM 199938005, the IRS required the inclusion of voting stock owned by a partnership in a decedent transferor's estate where the decedent held a general partner interest. However, some commentators believe the IRS's position is questionable since, according to state property law, a general partner is considered to have no direct or indirect rights in the partnership's property, including the stock of a closely held corporation owned by the partnership. The partnership, rather than the general partner, owns the voting rights.

In any event, the following strategies may alleviate at least part of the problem:

a. The corporation could recapitalize prior to funding a limited partnership and issue voting and nonvoting stock. The client could then fund the partnership with the nonvoting stock (which would hold the majority of the corporation's value). Thus, only the voting stock that was held outside the partnership would be included in the gross estate.

b. The partnership agreement could be drafted so that all partners could vote the stock in accordance with their partnership interests. In that situation, only the decedent's prorata share of the stock (corresponding to his partnership interest) would be at risk under IRC Sec. 2036(b).

Business Assets

Property owned by a corporation can be difficult to withdraw without adverse tax consequences. A corporation generally must recognize gain at the corporate level, while the recipient shareholder also must recognize gain. A

better alternative may be for a partnership to own business-related real estate and equipment and lease it to the corporation. Depending on the client's objectives, the partners can be persons who are active in the business and/or other family members who are not active in the business. This strategy provides a number of benefits, in addition to the avoidance of double taxation, including:

a. A diversion of corporate earnings to the partners, who are most likely family members, including those who are not active in the business. For example, by placing only the active operating assets (e.g., receivables, inventory, and equipment) within the corporation, the corporate stock can be directed to the family members who are active in the enterprise. The real estate and other passive assets can be placed in a family partnership for lease to the corporation.

b. Ensuring the continued availability of the assets to the corporation. Assets that are retained outside the corporation must be made available to the corporation if it is to continue using them. But if the lessors and the corporate shareholders are different parties, the business risks losing access to the use of the assets. This risk can be minimized by placing those assets in a family limited partnership. This can allow control of the assets to be in the hands of the parent(s) or those who actively operate the business but permit most of the equity and income to flow to the heirs.

c. Possible avoidance of an unreasonable compensation attack on the corporation, since the lease payments would provide a separate source of support, and the corporation's net earnings would be reduced by the amount of the lease payments.

d. Avoidance of unnecessary accumulation of earnings at the corporate level, which could lead to a smaller taxable estate for the parents.

e. Protection of the assets from creditors of the corporation/risks arising from the corporation's various business activities. While removing the assets from the corporation forgoes the liability shield provided by the corporate form of business, these assets can be protected through proper insurance coverage and/or operating the partnership as a limited liability company (LLC).

f. Providing a source of earnings and cash flow to the partners that is exempt from the self-employment tax per IRC Sec. 1402(a)(1). Furthermore, rent can be paid into the partner's retirement years with the reasonableness of the payment measured by the market value of the asset, not by the value of any services that are (or are not) provided to the corporation.

Life Insurance

A family partnership may be an attractive alternative to an irrevocable trust as a way to own life insurance. Partnership agreements can be amended, while irrevocable trusts generally may not. Furthermore, partnerships also avoid some of the more difficult aspects of dealing with life insurance trusts, such as *Crummey* invasion powers and the transfer-for-value rule.

Assuming the policies are owned by the partnership, the transferor-partner makes cash contributions to the partnership in exchange for partnership units, which he gifts to the other partners (i.e., children). Upon the death of the insured, the partnership would receive proceeds as beneficiary of the policy, and can use the cash to purchase assets from the estate to create liquidity, as would a trust. The proceeds will not be included in the gross estate, assuming the decedent retained no incidents of ownership.

Inappropriate Assets to Contribute to a Partnership

S Corporation Stock. Stock in an S corporation should not be contributed to a partnership if retaining S status is important, because a partnership cannot be an S corporation shareholder. If S stock is used to fund a family partnership, the S election will be terminated.

While a partnership may not be a shareholder in an S corporation, there is no prohibition against an S corporation acting as a general partner in a partnership. In fact, using an S corporation as a general partner in a partnership is a common practice. The S shareholders can indirectly function as general partners via their stock ownership and be personally protected from creditors of the partnership via the liability protection afforded by the corporation.

Professional Corporation Stock. Stock in a professional corporation, such as a medical practice, is usually not a viable asset for transfer to a partnership, since state laws usually require the stock to be held by the professionals individually.

Limited liability partnerships (LLPs) and variations thereof (such as professional limited liability partnerships) are a special type of general partnership. In some states, LLP partners remain personally liable for the commercial and other obligations of the entity, their own acts and omissions, and for the acts and omissions of persons under their supervision. However, they generally are not liable for acts and omissions of the other LLP partners and nonsupervised employees. But in most states, LLPs provide the same liability protection as LLCs.

Personal (Nonbusiness-related) Assets. As discussed at the beginning of this lesson, assets held by a partnership must be related to a trade or business, investment, or income-producing venture. Thus, personal assets are inappropriate for transfer to a partnership. In addition, the client may lose his or her homestead exemption for property tax purposes if the personal residence is used to fund a family partnership.

Retirement Plan Assets. Funding a partnership with retirement plan accounts, including IRAs, will constitute a taxable distribution of the account. In addition, a partnership may not be named a designated beneficiary of a retirement plan account.

Assets Used in a Passive Activity

If an active business generating operating losses is transferred to a limited partnership, the limited partners will end up with passive activity losses. If the limited partners do not have any passive income to offset these losses, the losses will be suspended until passive income is generated or until the passive activity is disposed of in a taxable disposition. Any trade or business activity in which a taxpayer materially participates is not considered a passive activity. The material participation standard is met by involvement in the operations of the activity on a regular, continuous, and substantial basis.

Except as provided in regulations, an interest as a limited partner is not treated as an interest in which a taxpayer materially participates. (Under one exception, losses attributable to limited partner interests are nonpassive where the limited partner is also a general partner and participates as such.) Therefore, extra thought should be given to contributing a trade or business that consistently generates losses to a limited partnership, since it is possible that some of those losses cannot be used in the year generated.

ALTERNATIVES TO CONTRIBUTING PROPERTY

Instead of contributing property, a partner can sell the property to the partnership. Such transfers, however, may be subject to special tax rules limiting the recognition of loss or recharacterizing gain when the sales are between related parties. The property can also be transferred to the partnership in a part sale, part contribution transaction, or by a sale of interests in the property to other partners followed by a joint contribution. If the purpose of the contribution is to provide cash to the partnership, taking out a loan against the property may be preferable to a cash contribution. If the purpose of the contribution is to give the partnership use of the property, a lease may be an appropriate alternative. While a contribution is often a convenient and beneficial way of transferring property to a partnership, another alternative may be more appropriate to the needs of the partners in particular circumstances.

Loaning Money to the Partnership

A loan from a general partner to his or her partnership is generally subordinate to third-party creditors. However, partner loans do take priority over a return of capital to partners.

Example 1-30: Comparing loan to additional capital contribution.

Matt and Cody are forming an equal general partnership to sell sports equipment. Matt plans on contributing $20,000 cash. Cody will contribute $10,000 cash plus provide services to the partnership. In this scenario, Matt is contributing $10,000 more than Cody. Matt may choose to either loan the additional $10,000 to the partnership or treat it as an additional capital contribution.

If the loan route is taken and the partnership loses its entire $30,000 cash contribution and liquidates, Matt and Cody will each have the following capital account balance:

Beginning capital contribution	$ 10,000
Less 50% share of partnership loss	(15,000)
Resulting capital account balance	$ (5,000)

Thus, the partnership's balance sheet will be as follows:

Total assets	$ -0-
Loan from Matt	$ 10,000
Matt's capital	(5,000)
Cody's capital	(5,000)
Total liabilities and capital	$ -0-

Thus, the partnership owes Matt for the $10,000 loan. Matt effectively owes himself 50% of that loan. Matt can proceed against Cody individually to collect the remaining $5,000.

Variation: Assume the same facts, except Matt decides to treat the entire $20,000 as a capital contribution. In that case, the partner's capital account balances would be:

	Matt	**Cody**
Beginning capital	$ 20,000	$ 10,000
50% of partnership loss	(15,000)	(15,000)
Ending capital	$ 5,000	$ (5,000)

In this scenario, Matt can still proceed against Cody to collect his $5,000 positive capital balance at the time of liquidation. Thus, under either the loan or contribution alternative, Matt would still have the right to recover $5,000 from Cody.

Note that loans from limited partners are treated slightly different. Generally, a partnership's obligation to repay limited partner loans is not subordinated to the claims of third-party creditors.

Payments made to a partner for the use of capital are guaranteed payments that are deductible by the partnership and reported as ordinary income by the partner. Partners must include the guaranteed payment in income in his or her tax year within or with which ends the partnership's tax year in which it deducts the payment. Partner loans are subject to the computation of interest income which is reported by the partner as such and deducted by the partnership as interest expense. Thus, there could be a timing difference of when income resulting from these alternatives would be recognized by the partner.

Selling Property to the Partnership

The sale of appreciated property from a partner to a partnership will result in gain recognition to the partner (usually capital gain). This in turn will result in the partnership having an increased basis in the purchased property. This result would be beneficial if the selling partner is in a low tax bracket, and the basis increase will produce depreciation or other deductions that will reduce partnership ordinary income that will be allocated to higher-bracket partners. The possibility that a sale will be more attractive than a contribution of property will depend partially on the preferential capital gain rate that applies.

A partner's sale of property with a decreased value to a partnership can only provide a current benefit to the partner if the partner owns (actually or constructively) 50% or less of the capital or profits in the partnership. If the partner owns more than 50% of the capital or profits interest in the partnership, IRC Sec. 707(b)(1) will prevent the partner from recognizing the loss.

Leasing Property to the Partnership

A lease between a partner and partnership will be treated as if it were between unrelated taxpayers. Such leases should be in writing and carry a fair rental value. A lease may be preferred over a capital contribution if it avoids the complexities associated with special allocations of items such as income and depreciation when its value differs from its basis. However, there is generally no advantage to leasing property under the passive loss rules.

ADDRESSING THE CONTRIBUTION OF ASSETS IN THE PARTNERSHIP AGREEMENT

One of the first steps in the formation of a partnership is determining how much capital is required and how the partners will contribute that capital. Generally, any contribution of tangible or intangible property is permitted. A contribution of current or future services or a contribution in the form of a guarantee of partnership debt may also be permitted. The partnership can restrict the types of contributions that may be made by the partners by appropriate provisions in the partnership agreement.

Types of Contributions. The documents should clearly define the types of property that partners can contribute to the partnership. Generally, these provisions should be as broad as possible to permit flexibility. However, when the partnership will be entering a capital-intensive business, or when there will be a need for working capital, the ability of the partners to contribute services or noncash assets should be somewhat limited. Furthermore, when a contribution of services is permitted, the tax issues connected with such a contribution should be considered, including whether a Section 83 election should be made. Additionally, the partnership agreement should specify when the partnership interest will be transferred in exchange for the services. It is normally a good idea to wait until the services have been satisfactorily rendered before transferring the interest to the service provider.

Valuation of Contributions. The partnership agreement should specifically address how contributions will be valued. State statutes generally permit the partnership and its partners to value contributions using any reasonable means, provided all agree to the method of valuation. Accordingly, the documents should provide a specific method or formula for the valuation of partner's contributions and should indicate that all partners agree to the use of the method or formula. In most cases, it is simplest to provide that an independent appraisal will determine the value of any noncash assets contributed. The standard of value should also be specified, since there may be a major dispute over whether the valuation should consider any discount for the size or marketability of the interest received. However, when the cost of an appraisal may be prohibitive, alternate valuation methods can be used. In any event, the documents should spell out exactly how the value of contributions will be determined. Improper valuation of contributions may permit creditors to argue that the contributing partners have additional liability. Additionally, when appreciated property is contributed, the valuation on the date of contribution is critical because IRC Sec. 704(c) requires that pre-contribution gain be allocated to the partner contributing the property.

If services are to be contributed, it is critical that some method be provided to value the services, not only for tax purposes, but to prevent future arguments among the partners concerning the value of the services rendered. If partners contribute loans or debt guarantees, the fair value of the contribution must also be determined. If guarantees are contributed, some recognition of the potential need for increases or decreases in the amount guaranteed should be addressed. The partnership agreement should also state what compensation, if any, will be paid to a partner for a guarantee or loan. If the guarantees are to be performed in the future, the partnership should consider discounting the value of the services to their present value using a reasonable discount rate.

Contributions of Future Services. If a partner's contribution consists of future services or loan guarantees, a timing issue must be addressed. When property, services, or loan guarantees are not immediately transferred, the partner receives a partnership interest in exchange for a promise to perform services, contribute property, or guarantee debts. The partnership should determine whether an immediate interest in the partnership in exchange for some future performance is equitable, or whether the interest should be transferred to the partner only upon performance of the service, transfer of the property, or guarantee of the debt. (In addition the practitioner should consider the Section 83 rules, which provide that a partner receiving an interest subject to a substantial restriction may not be considered a partner for tax purposes until the restriction lapses.) If the services are to be performed more than six months after the interest is transferred, the partnership should consider discounting the value of the

services using a reasonable interest rate. The ability to defer the transfer of the interest until performance of the promise varies from state to state, requiring a review of the appropriate partnership statute.

Required Future Contributions. Generally, most statutes permit, but do not require, a partnership to require partners to make contributions subsequent to the date of formation. If the partnership wants to provide for future contributions, the documents should specify the events that trigger the additional contribution, how the amount of the additional contribution is determined (if not a set amount), whether the additional contributions will be mandatory, and what enforcement provisions will be available if a partner or partners fail to or refuse to make the additional contributions. These enforcement provisions can include an assessment of interest (usually tied to some published rate), forfeiture of distributions until the capital contribution is paid in full, or forfeiture of some or all of the partner's interest. Such provisions may also give creditors of the partnership the right to enforce a partner's contribution obligation, however. Some state partnership statutes contain default enforcement procedures that apply if no other provisions are included in the partnership agreement. The tax consequences of a change in ownership as a result of a failure to make a capital contribution are unclear. Arguably, under general tax concepts, the contributing partners may have income as a result of a receipt of the ownership interest if the FMV of the interest exceeds their contributed capital. Likewise, the defaulting partner may well be deemed to receive a liquidating distribution because of his reduced ownership, which may create taxable income.

Discretionary Contributions. The documents should also address the issue of whether discretionary capital contributions will be permitted. Since a partner's interest in partnership income and profits may be determined based on the partner's capital account, this can be an important decision. Discretionary contributions may be of critical importance when voting rights are based on partner's unreturned capital and a discretionary contribution could result in a change in voting control. If discretionary contributions are permitted, such contributions should be permitted no more frequently than annually, and the partners should have a limited period of time to make the contribution. Normally, this should be 90 to 120 days. Further, this right to make additional contributions should not be cumulative. As an added precaution, the partnership agreement should prohibit any discretionary contribution within 60 or 90 days of any vote, thereby preventing a partner from attempting to increase his voting rights. The documents should also address whether or not the partnership can endorse or guarantee a loan to the partner for the contribution.

Preferential Returns. It is becoming more common to provide a preferential return to those partners contributing substantial amounts of capital. The purpose of the preferred return is to compensate the partner for the use of their capital. The payment of the preferred return has a number of tax and economic implications and raises some tax issues that should be addressed in the partnership agreement.

The partnership agreement should make it clear that the payment of the preference does not reduce the partner's capital, but is a return on that capital. Additionally, the partnership agreement should provide a clear basis for computing the preference, such as the original contributed capital plus any additions, less any distributions (other than the preferred preference). Where capital contributions can be paid through installments, the preferred return should be calculated based only on the actual contributions paid, not the total amount committed. The contribution is in the form of property, the preference should be paid on the value of the property. Generally, the value of the property at the date of contribution should be used, without considering future increases in value, since those increases are then on partnership property.

Several other issues must be addressed, including whether the preference is guaranteed (and possibly a guaranteed payment under IRC Sec. 707) and whether it is cumulative. A preference will be a cumulative preference if, when payment is missed in one year, it must be paid in a future year. Another issue that must be considered is whether the preference is part of a partner's allocation or in addition to the allocation. If the preference is part of the partner's allocation, the partner will receive the preference first, but then his ultimate allocation of income or cash will be reduced by the preference. On the other hand, if the preference is truly a preference, it will be paid in addition to the partner's share of partnership income.

If the preference is guaranteed, then the impact of the partnership's income being less than the preference must be addressed in the partnership agreement. The partnership has three options. First, the partnership could provide that the partner receiving the preference does not receive the entire preference. In that case, without a cumulative preference provision, the partner simply does not receive the entire preference. Alternatively, the agreement can

provide the shortfall is borne pro rata by all the partners (including the partner receiving the preference), which could then require additional capital contributions from other partners. Finally, the entire shortfall could be borne by the partners other than the partner receiving the preference. As with the second option, this may require additional capital contributions.

The preference will also impact distributions received upon the partnership's liquidation. To the extent that the preference reduces the partner's capital account, the payment of a preference will ultimately reduce the partner's liquidation proceeds, which can reduce the benefit of providing a preference.

Tax consequences must also be considered in drafting provisions regarding preference payments. First, if the preference is in addition to a partner's profit sharing percentage or share, the partnership agreement should provide an allocation of income equal to that preference. Next, the partnership agreement should coordinate the tax treatment of the preference with the overall tax allocation provisions to avoid confusion or challenge upon audit. Finally, if there is a cumulative preference, the agreement should specify how, for tax purposes, the payment of any accumulation is treated on liquidation.

Contribution of Partner Loans. When capitalization of the partnership includes both capital contributions and partner loans, or when the partnership wants to permit partner loans, the partnership agreement should include provisions that both permit the loans and outline the terms and conditions governing them. For example, the agreement may establish the conditions under which the loans are permitted, minimum or maximum repayment periods, interest rate options, and whether the loan can be collateralized with partnership assets. If the loans can be collateralized by partnership assets, the partnership agreement should provide for appropriate subordination of the partner loan in the event that other financing is necessary. Furthermore, the agreement should make it clear that such loans are not part of the partner's capital, but reflect a true debtor-creditor relationship. Of course, interest should be regularly paid on the loan. The agreement should also specify whether partner loans can or must be subordinated to other financing.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Chad and Dean are forming CAD Partnership, a 50/50 general partnership, to operate a small contracting business. Chad contributes $20,000 cash. Dean contributes equipment with a $20,000 FMV that he acquired four years earlier for $20,000. Dean has been depreciating the equipment using straight-line MACRS over a five-year period. The equipment has a $6,000 adjusted basis and is not subject to any liabilities. The partnership will use the traditional method for allocating built-in gain on the contributed property. Any tax gain from the sale of the property will be allocated to Dean first to offset the effect of the ceiling rule limitation. How much gain will Dean recognize on the contribution?

    a. $6,000.

    b. $14,000.

    c. $20,000

    d. None.

28. In accordance with proposed regulations, which of the following statements is accurate regarding noncompensatory options for partnership interests?

    a. Generally, issuing a partnership interest to the holder of a noncompensatory option should be taxable to the holder.

    b. IRC Sec. 721 applies only to the partnership upon the exercise of a noncompensatory option issued by the partnership.

    c. If an option lapses, the former option holder contributes property to the partnership in exchange for an interest in the partnership.

    d. Income recognition by the partnership and loss recognition by the former option holder results from the lapse of an option.

29. Which of the following requires a partner to recognize gain on a partnership distribution if cash or the value of marketable securities distributed is greater than the partner's adjusted basis in his partnership interest immediately prior to the distribution?

    a. IRC Sec. 704(c).

    b. IRC Sec. 721(b).

    c. IRC Sec. 731.

    d. IRC Sec. 737.

30. Which of the following business assets would be most able to avoid adverse tax (double taxation) consequences?

    a. Property owned by a corporation that is withdrawn.

    b. Property transferred to a recipient shareholder.

    c. Partnership-owned business-related real estate leased to the corporation.

31. Of the following assets, which one is best suited for transfer to a partnership?

    a. Personal residence.

    b. Mineral interests.

    c. Medical practice.

    d. Retirement plan assets.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Chad and Dean are forming CAD Partnership, a 50/50 general partnership, to operate a small contracting business. Chad contributes $20,000 cash. Dean contributes equipment with a $20,000 FMV that he acquired four years earlier for $20,000. Dean has been depreciating the equipment using straight-line MACRS over a five-year period. The equipment has a $6,000 adjusted basis and is not subject to any liabilities. The partnership will use the traditional method for allocating built-in gain on the contributed property. Any tax gain from the sale of the property will be allocated to Dean first to offset the effect of the ceiling rule limitation. How much gain will Dean recognize on the contribution? **(Page 261)**

    a. $6,000. [This answer is incorrect. $6,000 is the adjusted basis of Dean's equipment.]

    b. $14,000. [This answer is incorrect. $14,000 is the difference between the FMV of the equipment Dean contributed and its adjusted basis.]

    c. $20,000. [This answer is incorrect. $20,000 is the FMV of the equipment Dean contributed to CAD.]

    d. None. [This answer is correct. Dean recognizes no gain on the contribution and, thus, will have no recapture income. Chad will have a $6,000 basis in the equipment, and Dean will have a $6,000 basis in his partnership interest.]

28. In accordance with proposed regulations, which of the following statements is accurate regarding noncompensatory options for partnership interests? **(Page 262)**

    a. Generally, issuing a partnership interest to the holder of a noncompensatory option should be taxable to the holder. [This answer is incorrect. In most cases, issuing a partnership interest to the holder of a noncompensatory option should *not* be taxable to either the holder *or the partnership*.]

    b. IRC Sec. 721 applies only to the partnership upon the exercise of a noncompensatory option issued by the partnership. [This answer is incorrect. Upon the exercise of a noncompensatory option issued by the partnership. IRC Sec. 721 applies to both the holder and the partnership.]

    c. If an option lapses, the former option holder contributes property to the partnership in exchange for an interest in the partnership. [This answer is incorrect. The former option holder does *not* contribute property to the partnership in exchange for an interest in the partnership if an option lapses.]

    d. Income recognition by the partnership and loss recognition by the former option holder results from the lapse of an option. [This answer is correct. In concert with general tax principles, the lapse of an option will normally result in income recognition by the partnership and loss recognition by the former option holder.]

29. Which of the following requires a partner to recognize gain on a partnership distribution if cash or the value of marketable securities distributed is greater than the partner's adjusted basis in his partnership interest immediately prior to the distribution? **(Page 265)**

    a. IRC Sec. 704(c). [This answer is incorrect. IRC Sec. 704(c) addresses precontribution gain related to a marketable security to be allocated to the contributing partner upon any subsequent distribution of the asset to another partner.]

    b. IRC Sec. 721(b). [This answer is incorrect. Under IRC Sec. 721(b), the partnership may generally be classified as an investment company if more than 80% of the partnership's assets are held for investment and are in the form of stocks and securities, mutual fund shares, and REIT units.]

    c. IRC Sec. 731. [This answer is correct. If cash or the value of marketable securities distributed exceeds the partner's adjusted basis in his partnership interest immediately before the distribution, IRC Sec. 731 requires a partner to recognize gain on that partnership distribution.]

    d. IRC Sec. 737. [This answer is incorrect. IRC Sec. 737 may cause gain to be recognized when a partner contributed appreciated securities and within seven years receives a distribution of other property.]

30. Which of the following business assets would be most able to avoid adverse tax (double taxation) consequences? **(Page 265)**

    a. Property owned by a corporation that is withdrawn. [This answer is incorrect. Property that is owned by a corporation can be difficult to withdraw without experiencing adverse tax consequences.]

    b. Property transferred to a recipient shareholder. [This answer is incorrect. A recipient shareholder to whom property is transferred must recognize gain from such action.]

    c. Partnership-owned business-related real estate leased to the corporation. [This answer is correct. To avoid double taxation, a partnership can own business-related real estate and equipment and lease it to the corporation. The partners can be those who are active in the business and/or other family members who are not active.]

31. Of the following assets, which one is best suited for transfer to a partnership? **(Pages 265 & 267)**

    a. Personal residence. [This answer is incorrect. If the personal residence is used to fund a partnership, the owner may lose their homestead exemption for property tax purposes.]

    b. Mineral interests. [This answer is correct. Mineral interests are normally appropriate for funding a partnership. However, any environmental risks should be overcome with ample insurance.]

    c. Medical practice. [This answer is incorrect. State laws usually require the stock in a medical practice to be held individually by the professionals, not a partnership.]

    d. Retirement plan assets. [This answer is incorrect. If a partnership is funded with retirement plan assets, such action will constitute a taxable distribution of the account. Furthermore, a partnership may not be named a designated beneficiary of a retirement account.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (TPSTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following statements regarding contribution obligations is accurate?

   a. All state statutes recognize and enforce verbal contribution obligations.

   b. Most state statutes recognize and enforce either verbal or written contribution obligations.

   c. Most state statutes recognize and enforce only written contribution obligations.

   d. All state statutes require written contribution obligations.

2. On February 1, Louise, Linda, and Leann formed 3L Dresses and Gowns, a general partnership, to conduct a small retail business. Louise made a contribution of cash to the partnership, Linda contributed equipment she had owned for two years, and Leann contributed inventory she had acquired 6 months previous to formation of the partnership. Louise is contemplating selling her partnership interest to Leann for a profit, and the partnership is considering selling some of the equipment contributed by Linda. 3L Dresses and Gowns has a two-year holding period for the contribution of capital assets or Section 1231 property. Which of the following has a holding period in the partnership interest received that begins February 1?

   a. Louise.

   b. Linda.

   c. Leann.

   d. Louise, Linda, and Leann.

3. Contributions of Section 751 hot assets within _______ of a sale or exchange are disregarded if the partner recognizes ordinary income or loss as a result of the sale or as the result of a sale of the property by the partnership.

   a. One year.

   b. 18 months.

   c. Two years.

   d. Do not select this answer choice.

4. The nonrecognition rule for property contributions to a partnership may **not** apply to:

   a. Contract rights.

   b. Property subject to liabilities.

   c. Technical knowledge.

   d. Trade secrets.

5. In accordance with a federal appeal court's ruling, although a letter of intent is not binding, it constitutes property with value similar to:

   a. Money.

   b. Ownership of equipment.

   c. Goodwill.

   d. Contract rights.

6. Of the following classes of property, which of the following does **not** qualify under the definition of stocks and securities for investment company purposes cited in IRC Sec. 351(e)(1)(B)?

   a. Stock and other equity interests in a corporation.

   b. Evidences of indebtedness, options, or forward or futures contracts.

   c. Notional principal contracts, derivatives, or foreign currency.

   d. Interest in a precious metal used in active conduct of a business after the contribution.

7. A portfolio is considered diversified pursuant to IRC Sec. 368(a)(2)(F)(ii) if a maximum of 25% of the value of the total assets contributed by the transferor is invested in stock and securities of any one issuer, and a maximum of 50% of the value of the total assets contributed by the transferor is invested in the stock and securities of ___________ issuers.

   a. Nine or fewer.

   b. Seven or fewer.

   c. Six or fewer.

   d. Five or fewer.

8. Currently, investment company rules are only applied to which of the following?

   a. Contribution of widely held developed real property or interests therein.

   b. Contribution of widely held undeveloped real property or interest therein.

   c. Partnerships and LLCs owning marketable stock and securities.

   d. Widely held oil and gas properties or interests therein.

9. When a partner contributes property to a partnership that is subject to a liability, which of the following circumstances applies?

   a. The contributing partner is fully responsible for the liability.

   b. The contributing partner is responsible for any liability that does not exceed the property's FMV.

   c. The partnership assumes the liability up to the property's FMV on the contribution date.

   d. The partnership assumes the full liability of the property on the contribution date.

10. Robert and David intend to form R&D Enterprises (R&D), a general partnership, to remodel and operate a small strip shopping center in a building owned by David. The parties agree that Robert will contribute $70,000 cash for a 50% interest. For the other 50% interest, David plans to contribute the building, which has a $175,000 FMV and is subject to a fully recourse mortgage of $105,000 incurred to acquire the property. David's depreciated basis in the property is $60,000. David ultimately contributes the building to R&D. What is the amount of gain that David would recognize?

    a. $0.

    b. $2,500.

    c. $5,000.

    d. $7,500.

11. Obligations under derivative financial instruments may include any of the following **except**:

    a. Options.

    b. Swaps.

    c. Tort obligations.

    d. Futures contracts.

12. Under certain exceptions the subsequent transfer of the contributor's partnership interest, liquidation of the contributor's partnership interest, or the assumption of the transferred liability by a different partner does not require application of Reg. 1.752-7 rules. An exception applies if immediately preceding the testing date, the remaining built-in loss on all Reg. 1.752-7 liabilities assumed by the partnership, other than ones assumed in connection with an associated trade or business in one or more Reg. 1.752-7 liability transfers, is less than (a) the lesser of 10% of the partnership's gross value or (b):

    a. $500,000.

    b. $1,000,000.

    c. $1,250,000.

    d. $1,500,000.

13. The disguised sale rules generally would **not** apply to which of the following types of contributions?

    a. A contribution to the partnership followed closely by a distribution to the contributing partner.

    b. One partner relinquishes a portion of his or her rights to future profits, and another partner obtains those rights by assuming future capital contribution obligations of the first partner.

    c. A contribution to the partnership of unencumbered property by a partner that is not followed by a cash distribution from the partnership to a partner (or vice versa).

    d. Constructive contributions and distributions arising from shifts in partnership liabilities.

14. If a transaction is treated as a disguised sale under IRC Sec. 707, it is also treated as a sale under which of the following Code provisions that deals with the determination of gain or loss?

    a. IRC Sec. 1001.

    b. IRC Sec. 1012

    c. IRC Sec. 1031.

    d. IRC Sec. 1274.

15. IRC Sec. 1274 establishes the issue price of any obligation that does not bear interest as long as the payments are received ___________ after the sale date.

    a. At least 60 days.

    b. At least 90 days.

    c. More than 120 days.

    d. More than 6 months.

16. Notwithstanding the facts-and-circumstances test established in Reg. 1.707-3(c)(1) and (d) for determining if a transaction is a disguised sale, transfers made within ____________ are presumed to be a sale.

    a. A two-year period.

    b. A three-year period.

    c. A four-year period.

    d. A five-year period.

17. Which of the following circumstances would make it possible to avoid disguised sale treatment?

    a. The timing and amount of a subsequent transfer can be reasonably determined at the time of the earlier transfer.

    b. A preferential distribution of cash flow that is matched by an allocation of income/gain to a partner with an amount that is reasonable.

    c. Any person has made or is legally required to make contributions to the partnership to permit the partnership to transfer money or other consideration.

    d. The partnership has money or other liquid assets that are outside the reasonable needs of the business that are expected to be available to make the transfer.

18. Disguised sale rules do not apply to reimbursement of the partnership's preformation expenses if the distribution reimburses a partner for expenses that were incurred during the two-year period prior to the transfer, and such expenses were incurred with respect to contributed property; however, incurred expenses can only be an amount that does not exceed _______ of the FMV of the property at the time of contribution unless the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the property on the contribution date. If the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the property on the contribution date, incurred expenses are not limited.

    a. 10%.

    b. 15%.

    c. 20%.

    d. 25%.

19. In January 2010, Bill and Sarah form B&S Investment Partnership to provide leasing services for commercial office space. Bill contributes $700,000 cash, and Sarah contributes an office building with a $1 million FMV and a $600,000 adjusted basis. The office building is encumbered by a $700,000 nonrecourse liability Sarah incurred in 2009 to finance the acquisition of other property. All partnership items all allocated equally between Bill and Sarah. The nonrecourse liability secured by the office building is not a qualified liability, since it was incurred within the two-year period prior to contribution and is not acquisition debt. As a result, the assumption of a portion of the liability by Bill is treated as consideration to Sarah. Sarah's share of the nonrecourse debt (under a facts-and-circumstances analysis) is 50%. Sarah is deemed to have received a cash distribution equal to 50% of the liability, or $350,000. A disguised sale has occurred even though Sarah has not received an actual cash distribution. Sarah is considered to have sold a 25% interest in the building (which had a $1 million FMV) to the partnership for $250,000. B&S Investment Partnership has purchased 25% of the office building for $250,000 and received the other 75% of the building as a capital contribution. The partnership's adjusted basis in the building is:

    a. $675,000.

    b. $700,000.

    c. $725,000.

    d. $775,000.

20. In February 2010, the Blue Ridge Partnership, a real estate development company, approached John and Harry concerning two pieces of real estate they owned. In exchange for the property, John and Harry would receive limited partner interests in Blue Ridge. In accordance with an integrated plan, the transfers were scheduled to take place in April 2010, at which time both John and Harry would each become one-third limited partners in Blue Ridge. At that time, John's property, Property 1, had a $50,000 FMV, a $30,000 adjusted tax basis, and a $30,000 nonrecourse liability. John obtained the note in April 2010 to pay off his personal credit cards. Property 2, owned by Harry, had a $50,000 FMV and a $20,000 adjusted basis. Harry obtained a $35,000 recourse note in April 2010 that was secured by Property 2. He used the proceeds to remodel his home. Pursuant to the plan, the partnership takes John's property subject to liability 1 and assumes liability 2 as part of the transaction. John has additional capital contribution requirements of $17,500. Since John and Harry transferred the two properties to Blue Ridge pursuant to a plan, Reg. 1.707-5(a)(4) applies, and the two liabilities (both of which are not qualified) assumed or taken subject to by the partnership are netted together to determine the amount of consideration John and Harry received from the partnership. According to Regs. 1.707-5(a)(2)(ii) and 1.752-3(a), which determine a partner's share of a nonrecourse liability, John and Harry are each allocated $10,000 of liability 1. John's share of liability 2 is $17,500 and Harry's share is zero, according to Regs. 1.707-5(a)(2)(i) and 1.75202, which determine a partner's share of a recourse liability. As a result, Blue Ridge has transferred consideration of $2,500 to John and $25,000 to Harry. Under Reg. 1.707-3, John is treated as having sold $2,500 of the FMV of Property 1, and Harry is treated as having sold $25,000 of the FMV of Property 2. John's gain on the portion of the transfers treated as sales under the disguised sale rules is $1,000. Harry's gain is:

    a. $15,000.

    b. $25,000.

    c. $30,000.

    d. $37,500.

21. Tax return disclosure by the transferor of the property is required by the disguised sale regulations if a partner treats a liability incurred as a qualified liability less than __________ prior to the transfer?

    a. 180 days.

    b. One year.

    c. Two years.

    d. Three years.

22. Of the following statements, which one is accurate regarding contributing of partnership debt?

    a. A partner's contribution of a partnership's own obligation usually results in cancellation of debt income.

    b. Gain or loss is generally recognized on contributions of property to a partnership.

    c. A debt-for-equity contribution in a partnership is generally treated as a nontaxable transfer.

    d. A reduction in the dollar amount of partnership liabilities does not trigger a reduction in the tax basis of each noncontributing partner in his or her partnership interest.

23. Robert, a real estate developer, formed Timber Lane Limited Partnership for the purpose of developing and operating an apartment building. Thirty-five limited partner units were offered to investors. Under the partnership agreement, limited partners make a $10,000 initial contribution. An additional $24,000 is due in three annual installments of $8,000 each. The amount of each installment was calculated to match the limited partners' share of partnership losses. Each limited partner must deliver a $24,000 promissory note to evidence the deferred capital contribution obligation. It should be noted that the promissory notes are not publicly traded. Timber Lane can either pledge or sell the promissory notes. Since additional cash is needed to operate the building, Timber Lane wants to either borrow the necessary funds and pledge the notes as security or sell the notes to a third party who has offered to purchase them at a reasonable discount. Partner A and Partner B contributed identical notes at the same time. Partner A's note is subsequently transferred to a third party, thus, the capital account of Partner B would be increased by his or her payments on the note to the partnership and Partner A's capital account would be increased only by the proceeds received from the third party. When the property is sold, how much "capital" is returned to Partner A?

    a. $8,000.

    b. $10,000.

    c. $24,000.

    d. $34,000

24. All of the following statements apply regarding the contribution of zero-basis receivables **except**:

    a. A partner's contribution of zero-basis receivables to a cash-basis partnership is treated as a property contribution.

    b. A partner's contribution treated as a property contribution is not subject to assignment-of-income principles.

    c. A partner's contribution treated as a property contribution may depend on whether the transaction has a business purpose.

    d. A partner's contribution treated as a property contribution may depend on whether tax avoidance motives or possibilities are present.

25. Pursuant to IRC Sec. 704(c)(1)(B), any precontribution gain or loss must be recognized by the contributing partner when property contributed by one partner is distributed to another partner within:

    a. 7 years.

    b. 9 years.

    c. 10 years.

    d. 12 years.

26. For corporate taxpayers, capital losses on dispositions of contributed property can only be used to offset capital gains; however, in accordance with IRC Sec. 1211, noncorporate taxpayers are allowed to deduct __________ of capital loss per year.

    a. $3,000.

    b. $4,000.

    c. $5,000.

    d. $7,000.

27. Andrew is a partner in Andrew Brothers Traders, a partnership that conducts an active securities trading business. On April 1, 2010, in lieu of a $20,000 cash capital contribution, Andrew contributed ABC Co. stock with a $20,000 FMV. Andrew acquired the stock three years earlier as a personal investment. His basis in the contributed stock was $26,000. On May 1, 2011, Andrew Brothers Traders sold the ABC stock for $18,000, recognizing a $8,000 loss. Andrew Brothers Traders is engaged in an active securities trading business and normally recognizes ordinary income or loss on its sale of securities held as trade or business assets. Upon the company's May 1, 2011 sale of stock, what is the amount that must be treated as a capital loss?

    a. $2,000.

    b. $3,000.

    c. $6,000.

    d. $8,000.

28. Assuming the same facts as the question above, how much will be related as an ordinary loss?

    a. $0.

    b. $2,000.

    c. $5,000.

    d. $6,000.

29. According to the IRS, which of the following may be taxed as depreciation recapture?

    a. The gain on the contribution of personal property to a partnership.

    b. The gain on the contribution of property subject to liabilities to a partnership.

    c. Soil and water conservation expenses.

    d. Intangible drilling and development costs.

30. According to proposed regulations issued by the IRS, upon the exercise of a noncompensatory option, the option holder usually receives a partnership interest with a value that is __________ the aggregate value of the premium and exercise price that the option holder contributes to the partnership.

    a. Greater than.

    b. Less than.

    c. Greater or less than.

    d. Equal to.

31. Which of the following types of assets transferred to the partnership would most likely **not** support a valid business purpose?

    a. Truck.

    b. Farm equipment.

    c. Household furniture.

    d. Stocks.

32. Which of the following statements is accurate regarding the relationship between S corporation stock and a partnership?

    a. Contributing S corporation stock to a partnership will help the partnership to retain S status.

    b. Using S corporation stock to fund a family partnership does not affect S status.

    c. An S corporation can act as a general partner in a partnership.

    d. A partnership can be an S corporation shareholder.

Lesson 2: Contributions of Services

INTRODUCTION

The taxation of partnership interests received for services has always been a troublesome issue for tax practitioners. Unlike contributions of property, which generally are nontaxable, the contribution of services in exchange for a partnership interest may be a taxable transaction.

The history of the tax treatment of service contributions is a confusing and contradictory tale of conflict between the Tax Court and the taxpayer. This lesson provides tips for dealing with the uncertainty engendered by the lack of guidance in this area.

Despite the confusing history, there are situations where a contribution of services is necessary or preferred. an individual may not have sufficient money or property to contribute, or he may want a larger partnership interest than his money or property could be exchanged for. he may also have an asset that he wants to continue to hold in his name, either for personal or legal reasons, and therefore, doesn't want to contribute it to the partnership.

This lesson reviews the tax consequences to the partner who receives a profits or capital interest in a partnership in exchange for services. This lesson also looks at the tax consequences to the partnership for which the services are performed. The service partner's recognition of compensation income, the valuation of the transferred interest, the effects of a substantial risk of forfeiture, and the optional election to be taxed upon receipt of an interest that is not substantially vested are all discussed in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Define the factors that affect the tax treatment of a service partner.
- Identify the benefits and risks of a Section 83(b) election.
- Determine how to value partnership interests acquired in exchange for services and the associated tax consequences.

TAX TREATMENT OF A SERVICE PARTNER

The general nonrecognition rule does not apply to the contribution of services by a partner to a partnership because the transfer of property in connection with the performance of services is a taxable transaction under IRC Sec. 83.

Applying the Section 83(b) Rules

There is some disagreement among practitioners concerning whether the Section 83 rules apply to transfers to partners for the performance of services. The uncertainty is caused by the statement in Reg. 1.83-1(a) that "Section 83 provides rules for the taxation of property transferred to an employee or independent contractor . . . in connection with the performance of services . . ." This statement leads some practitioners to believe that, since a partner cannot be an employee of a partnership, the Section 83 rules do not apply. However, it is generally believed that this is not an exclusionary statement in the regulations, and that the Section 83 rules apply to any transfer of property for the performance of services. (In fact, a regulation proposed in 1971, although not finalized, specifically extended the Section 83 rules to transfers of partnership interests.)

IRC Sec. 409A provides that amounts deferred under a nonqualified deferred compensation plan for all tax years are currently includable in gross income to the extent that they are not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. If a taxpayer fails to satisfy the provisions of IRC Sec. 409A, the taxpayer may be subject to an acceleration of income recognition and a penalty equal to 20% of the compensation that is required to be included in gross income and interest on the deferred amounts. The Section 409A rules governing other stock-based compensation may be applied to grants of equity-based compensation where the compensation is determined by reference to partnership equity. Section 736(a)

retirement payments to partners are not subject to IRC Sec. 409A unless they are treated as self-employment income. IRC Sec. 409A may apply to payments to a partner not acting in his or her capacity as a partner if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

The Treasury Department and the IRS issued final regulations in April 2007 which were generally effective as of January 1, 2009.

Determining When Property Is Considered Restricted

When property that is restricted (i.e., subject to a forfeiture risk) is transferred to the recipient for payment of services, the recipient's income and the partnership's deduction are not recognized until vesting occurs (i.e., the property is no longer restricted), unless the recipient makes an election under IRC Sec. 83(b) to recognize the income at the date of receipt. This ability to defer tax on the receipt of restricted property or to recognize income up-front creates planning opportunities that are discussed later in this lesson.

When property that is not restricted is transferred in payment for services, the recipient recognizes ordinary income equal to the property's value less any amount paid for the property on the transfer date. Here, little or no planning can be done to reduce or minimize taxes; however, with vested property, the recipient also avoids the risk of forfeiting the property.

Property is restricted (i.e., is substantially nonvested) when both of the following conditions are present:

a. *The Property Is Subject to a Substantial Risk of Forfeiture.* Property is subject to a substantial risk of forfeiture if the rights to its full enjoyment are conditioned (directly or indirectly) upon the future performance (or refrainment from performance) of substantial services by the recipient.

b. *The Property Is Not Transferable.* Property is transferable if the recipient can transfer any interest in the property to any person other than the partnership, and the transferee's rights in the property are not subject to a substantial risk of forfeiture. Therefore, the property is not transferable if the recipient can sell, assign, or pledge his interest in it to any person other than the partnership and such other person must give up the property or its value if the event causing the substantial risk of forfeiture occurs.

The key is whether the property is subject to a substantial risk of forfeiture. The second condition (property is nontransferable) simply ensures that, in a property transfer by the recipient, the recipient will also be subject to the substantial risk of forfeiture condition.

In the right circumstances, restricted property can allow the recipient to:

a. *Defer Tax.* The recipient is not taxed upon the receipt of restricted property, but is allowed to defer tax on the value of the property and any subsequent appreciation in the property's value until the property's restrictions lapse. However, the downside of the deferral, if the property appreciates, is more ordinary income when the property vests and less capital gain when the property is ultimately sold. The practitioner must evaluate whether the buildup of tax-free equity from the deferral of tax exceeds the after-tax income the recipient would earn by paying tax on the ordinary income up-front and paying tax on future appreciation as capital gain.

b. *Control the Timing of Income Recognition.* The ability to make a Section 83(b) election to recognize income upon the receipt of restricted property allows the recipient to plan the timing of income recognition on restricted property. The recipient can choose to recognize income upon receipt of the restricted property or when the property becomes substantially vested.

Defining a Substantial Risk of Forfeiture

Whether property is subject to a substantial risk of forfeiture depends on facts and circumstances. Property is subject to a substantial risk of forfeiture if the rights to its full enjoyment are conditioned (directly or indirectly) upon either of the following:

a. *Future Performance of Substantial Services.* A requirement of future performance (or refraining from performance) of substantial services by the recipient is a substantial risk of forfeiture. The regularity of the performance of services and the time spent in performing them tend to indicate whether the required services are substantial.

b. *Occurrence of a Condition Related to a Purpose of the Transfer.* For example, a requirement that the recipient complete an advanced educational degree, obtain a professional designation, or attain a certain job position within the company to receive unrestricted access to the property would likely be a substantial risk of forfeiture, which would exist until that condition was met.

The following generally do not constitute a substantial risk of forfeiture:

a. The risk that the value of the property will decline during a certain period.

b. A nonlapse restriction placed on the property (such as a restriction requiring the recipient to surrender the property if he or she leaves the partnership as well as a limitation subjecting the property to a permanent right of first refusal at a price determined under a formula).

c. A requirement that the property be returned if the recipient is discharged for cause or for committing a crime.

d. A requirement that the property be returned if the recipient accepts a job with a competing firm.

e. A requirement that the property be returned if a retiring recipient does not render consulting services upon the request of his former partnership (unless he is expected to perform substantial services).

Receiving Unrestricted Property for the Performance of Services

Under IRC Sec. 83, a person who receives unrestricted property in connection with the performance of services recognizes immediate taxable income. The income equals the FMV of the property received, reduced by the amount paid for the property.

Receiving Restricted Property for the Performance of Services

The following discussion addresses the rules that currently govern the receipt of a partnership interest in exchange for services. Practitioners should be aware that proposed regulations and Notice 2005-43 provide new rules and new safe harbor provisions that will apply to the receipt of a partnership interest by a service partner when the regulations are finalized.

If the property received in exchange for services is restricted, the amount and timing of the recipient's income recognition depends on the extent of the restrictions and the recipient's rights to full enjoyment of the property. The recipient is taxed when the property becomes substantially vested. This is deemed to occur when the recipient's rights in the property are no longer subject to a substantial risk of forfeiture or are transferable free of any such risk.

The amount of income recognized is the FMV of the property at the time of vesting, less any amount paid for the property. Thus, the existence of a restriction on the service partner's full enjoyment of the property (such as a requirement that the service partner continue to perform services for a stated period of time) affects the taxation of the transaction. (See Examples 2-1 and 2-7.) If the services provided during the period of the restriction add value to the partnership or the partnership's assets appreciate, the compensation recognized by the service partner increases.

If a substantially nonvested partnership interest transferred in connection with the performance of services is subsequently sold or otherwise disposed of to a third party in an arm's length transaction while still substantially nonvested, the person who performed the services realizes compensation in an amount equal to the excess of (1) the amount realized on the sale or other disposition, over (2) the amount (if any) paid for the partnership interest. The compensation is includible in the service provider's gross income in accordance with his or her method of accounting.

If a substantially nonvested partnership interest transferred in connection with the performance of services is disposed of in a transaction that is not at arm's length and the property remains substantially nonvested, the person who performed the services realizes compensation equal to the sum of any money and the FMV of any substantially vested property received in the disposition. The compensation is includible in gross income in accordance with his or her method of accounting. However, the amount of compensation recognized cannot exceed the FMV of the transferred partnership interest at the time of disposition (determined without regard to any lapse restriction), reduced by the amount paid for the interest. In addition, the Section 83 rules continue to apply with respect to the transferred interest, except that any amount previously includible in gross income as a result of the disposition is thereafter treated as an amount paid for the interest.

Identifying When a Substantial Risk of Forfeiture Exists. If full enjoyment of the property is conditioned upon the continued performance of services, the rights are subject to a substantial risk of forfeiture. A substantial risk of forfeiture also exists if the recipient's rights are subject to another condition, such as the recipient's refraining from competition for a specified period of time or the achievement of some goal related to the transfer (e.g., completing construction of a building, or a specified increase in earnings).

Absent a Section 83(b) election, a service provider recognizes income with respect to the receipt of property (e.g., a partnership interest) in the first tax year in which the service provider's rights to the property are not subject to a substantial risk of forfeiture or are transferable free of any such risk. (See Example 2-2.)

Even if the service partner pays full FMV for the interest, if his right to enjoy any increase in value of the interest is subject to a risk of forfeiture (e.g., if the partnership is entitled to liquidate the interest upon nonperformance by the partner by paying a specified price regardless of increases in value), the Section 83 rules will cause the partner to only be taxed as the true owner of the interest when the risk of forfeiture no longer exists. The service partner will then be taxed on the difference between the interest's value at that time and the amount paid for it, even though the service partner paid full value when he initially received the partnership interest. (See Examples 2-1 and 2-7.)

Identifying When the Transferee Is Considered a Partner

Until the property becomes substantially vested, the transferor is regarded as the owner of the property for tax purposes. Any *income* received by the service provider from holding the transferred property before vesting occurs is treated as compensation when received. These rules, apparently, were drafted without consideration of the complications they would cause in the partnership setting, and no explicit statutory exceptions exist that address application of the rules to partnerships.

Example 2-1: Postponing partner status when the partnership interest is subject to a substantial risk of forfeiture.

Arnie and Jack formed a 50/50 partnership, Eagle Co., by each contributing $200,000. Eagle Co. purchased land, a building, and related property. On January 1, 2009, in exchange for an agreement to manage the building, Gary was admitted to the partnership with a 10% interest in partnership capital, profits, and losses. Arnie's and Jack's capital accounts were each reduced to $180,000. Gary was credited with a $40,000 capital account and was entitled to share in income, losses, and current distributions based on his 10% interest. Under the agreement, however, Gary would forfeit the entire 10% partnership interest if he ceased performing building management services prior to July 1, 2010. Gary did not elect to be taxed immediately on this transfer. (See Example 2-7.)

For the partnership year ending on December 31, 2009, Gary was allocated $10,000 as his distributive share of the partnership's income (for book purposes only). On January 15, 2010, Gary received a $6,000 cash

distribution from the partnership. On July 1, 2010, Gary's partnership interest became fully vested when Eagle Co.'s net worth was $500,000.

Gary is not treated as a partner until his partnership interest becomes free of any substantial risk of forfeiture, on July 1, 2010. On that date Gary recognizes compensation equal to the FMV of the partnership interest. Assuming the FMV of the interest is measured by its share of Eagle Co.'s capital ($500,000), Gary will recognize $50,000 of income with respect to the receipt of the partnership interest. (If the interest had fully vested on January 1, 2009, he would have recognized only $40,000.)

Eagle Co. is treated as having been the owner of Gary's interest prior to July 1, 2010. Therefore, Gary apparently has no distributive share of Eagle Co.'s income before that date. The amount that otherwise would have been allocated to Gary is instead required to be reallocated between Arnie and Jack, making them taxed on $5,000 more of Eagle Co.'s 2009 income than would have been the case if Gary were recognized as a partner.

Similarly, Gary's $6,000 January 2010 distribution is not treated as a distribution to a partner. Instead, it is taxable as compensation paid to Gary. This is true even if the partnership has no income and the distribution is intended to be a return of capital. The partnership is entitled to deduct or capitalize the amount of the payment. The practitioner might suggest that the partners adopt special allocations to create distributive shares for each partner for 2010 that are as close as possible to the shares they would have had if Gary were a partner for the entire year. Any special allocations should take into account the tax effects of the vesting of the interest as well as the earlier cash distribution.

What would happen if, in the preceding example, only Arnie and Gary had formed Eagle Co., and Gary's interest was not vested? Arguably there would be only one *partner*, so no partnership would exist. The venture would be treated as Arnie's proprietorship until Gary's interest vested. Only at that time would the partnership be formed for tax purposes.

Under the conceptual framework established by the Code, the service provider is not treated as the property owner until the provider's rights to the property become substantially vested. As a result, an individual receiving a restricted partnership interest may be a partner under state law but may be treated as a nonpartner for tax purposes. Such a *nonpartner-partner* would not be taxed on his share of partnership income and loss, and any distributions to that partner would be taxed as compensation paid to a nonpartner.

Documenting the Contribution of Services

Practitioners should document the important details of the contribution of services in exchange for the partnership interest. At a minimum, the partnership will want to commit the following in the partnership agreement or a separate document:

a. Who will provide the services?

b. What services are to be provided?

c. What is the timeline for providing the services (one deadline or a scale of deadlines)?

d. Are there any conditions or contingencies present?

e. What are the consequences for failure to meet the deadlines?

DIFFERENCES BETWEEN CAPITAL AND PROFITS INTERESTS

Acquiring an Interest in Partnership Capital in Exchange for Services

The following discussion addresses the rules that currently govern the receipt of a partnership interest in exchange for services. Practitioners should be aware that proposed regulations and Notice 2005-43 provide new rules and

new safe harbor provisions that will apply to the receipt of a partnership interest by a service partner when the regulations are finalized.

It is clear under the regulations that the receipt of an interest in partnership capital is a taxable event if the interest is transferred to a partner as compensation for services. In Rev. Proc. 93-27, the IRS defines a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at FMV and then the proceeds were distributed in a complete liquidation of the partnership." All other interests are profits interests. The determination of whether an interest is a capital or profits interest is made at the time of receipt. If the transfer is made for past services performed by the partner, the amount of income recognized equals the FMV of the interest at the time of the transfer (subject to the Section 83 rules for restricted interests). If the transfer is conditioned on the completion of future services by the partner, the amount of income recognized is equal to the FMV of the interest at the time the services are rendered. These rules were promulgated prior to the inclusion of the Section 83 substantial risk of forfeiture rules, but are not inconsistent with those provisions. (See Examples 2-2, 2-9, and 2-11 for more detailed discussion of the tax effects when a capital interest is transferred in exchange for services.)

Example 2-2: Measuring the partner's taxable income from receiving a capital interest in exchange for services.

Fred Conrad and J.W. Hillman formed the Conrad Hillman Co., a general partnership, to acquire and operate a hotel. Conrad contributed $100,000 for a 75% partnership interest. Hillman will contribute services in acquiring and operating the hotel in exchange for an unrestricted 25% partnership interest. After the partnership was formed, it purchased an existing hotel for $400,000 by paying $80,000 down and obtaining a $320,000 mortgage.

The interest Hillman received constitutes property consisting of the rights granted to him under the partnership agreement. If the partnership had been liquidated immediately after Hillman acquired the interest, he would have received 25% of the partnership's net worth—or $25,000. Assuming this $25,000 represents the FMV of the partnership interest he received, Hillman, who paid nothing for the interest, must include the full $25,000 value in gross income as compensation in the year in which he receives the partnership interest (since Hillman's receipt of the interest is not subject to restriction).

Hillman's basis in the partnership interest includes the $25,000 of income that he recognizes upon receipt of the interest. If Hillman had paid anything for the interest by contributing to the partnership's capital, that amount would also be included in his basis but would reduce the amount of income he recognized [Reg. 1.722-1; compare Reg. 1.83-4(b)(1)]. For example, if he had paid $3,000, the income he recognized would be reduced to $22,000—the $25,000 value of the interest less the amount paid. The basis in the partnership interest would be $25,000.

In the preceding example, the tax practitioner, if consulted in advance, might have suggested that the arrangement be structured somewhat differently. For example, Hillman could agree to perform the services as an independent contractor in exchange for cash. The cash would be paid at specified times, after which he could make cash contributions to the partnership in amounts equal to the cash received. While this would not have avoided the recognition of income, it could have allowed the partners to plan the timing of Hillman's income recognition. The parties might also have considered having Hillman's interest vest in stages. Such vesting provisions could be used to plan the timing of Hillman's income recognition, although staged vesting could produce other tax consequences that must be considered. (See Example 2-1.)

Receiving a Profits-only Interest in Exchange for Services

The following discussion addresses the rules that currently govern the receipt of a partnership interest in exchange for services. Practitioners should be aware that proposed regulations and Notice 2005-43 provide new rules and new safe harbor provisions that will apply to the receipt of a partnership interest by a service partner when the regulations are finalized.

Neither the Code nor the regulations define *profits interest*. Regs. 1.721-1(b)(1) and 1.704-1(e)(1)(v) and Rev. Proc. 93-27, however, talk about capital interests in a way that indicates a profits interest is one that does not entitle the partner to share in partnership assets upon withdrawal from the partnership or upon its liquidation. Rev. Proc. 93-27

goes on to say a "profits interest is a partnership interest other than a capital interest" and defines a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at FMV and then the proceeds were distributed in a complete liquidation of the partnership." This definition would include the appreciation in value of partnership assets as part of the capital interest.

Example 2-3: Determining if a partnership interest is a capital or profits interest.

Mattco Partnership owns an apartment building with a $500,000 basis and an $800,000 FMV. Charlie has managed the apartment building for many years. On his 10th anniversary as an employee, Mattco admits Charlie as a partner, giving him a one-third profits interest including any gain subsequently realized on the sale of the building. This is in exchange for his continued management of the building.

The partnership agreement indicates that Charlie has no right upon withdrawal from Mattco to share in the partnership assets other than in the income earned but not distributed after his admission or assets acquired with that income.

In this case, Charlie has acquired a profits-only interest. If the building is sold while he is a partner, the appreciation that occurred both before and after his admission would be part of the partnership's profits in which he would share.

If the partnership agreement had allowed Charlie to share in the appreciation of the building whether or not he withdraws from the partnership, the interest would have been considered a capital interest.

Identifying When the Receipt of a Profits-only Interest Received in Exchange for Services is Taxable

Rev. Proc. 93-27 provides that the receipt of a profits-only interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner is generally not a taxable event. However, the receipt of such an interest may be taxable if:

a. the profits interest relates to a substantially certain and predictable stream of income from the partnership assets (such as a net lease);

b. the partner disposes of the profits interest within two years of receipt; or

c. the profits interest is a limited partner interest in a publicly traded partnership.

The rules outlined in the revenue procedure apply only when the interest is received in the transferee's capacity as a partner or in anticipation of becoming a partner. These guidelines may not apply if the partner receives the interest in his capacity as an employee or in the capacity of a nonpartner (e.g., a transfer to a lawyer or architect for professional services).

Example 2-4: Measuring the taxable income of a service partner receiving a profits-only interest.

Danny and Thomas form Leventwelve, a general partnership, to develop land that Danny owns. The land Danny contributes has a $200,000 FMV and a $160,000 basis. Danny's book capital account is credited with $200,000, and he receives a 75% interest in partnership profits and appreciation. Thomas agrees to perform services in developing the land in exchange for the remaining 25% of partnership profits and appreciation. Thomas's book capital account has an initial balance of zero. They agree the value of Thomas's interest is also zero, since Leventwelve's activities are speculative.

Under IRC Sec. 83, at the time the partner's interest is first free of substantial risk of forfeiture or is transferable free of such risk, the partner is taxed on the difference between the interest's FMV and the amount, if any, paid for the interest. The partner's partnership interest basis equals the income recognized plus any amount paid for the interest. Since the FMV of Thomas's interest is zero, the receipt of the interest does not result in taxable income. By definition, the service partner acquires no interest in partnership capital, and one must presume the service partner's book capital account equals zero.

As a practical matter, in many partnership situations, the parties can justify attributing a negligible or zero FMV for a profits-only interest. This would seem appropriate in Thomas's case in Example 2-4, since he has not yet performed significant services, and those future services will be a material factor in determining whether or not he actually realizes any value from the interest. This is usually the case in service partnerships, where the income to be allocated to the service partner may not be determined until after both the partnership's income and the service partner's contributions are known, and where there also may be dramatic shifts in income sharing from time to time. In such scenarios, there are no immediate tax implications for the partnership or the partner.

Example 2-5: Taxing a service partner receiving a profits-only interest when the interest is disposed of within two years.

Assume the same facts as in Example 2-4, except Thomas performed preliminary work in developing the land prior to Leventwelve's formation, and he sells his interest four weeks after the partnership's formation for $50,000.

Since Thomas sold his interest within two years of receipt, he falls within one of the exceptions in Rev. Proc. 93-27, clarified by Rev. Proc. 2001-43. Therefore, the receipt of his interest is treated as a taxable event under the general guidelines of the procedure. Unless facts and circumstances indicate otherwise, the interest's value on the receipt date is deemed to be $50,000, and Thomas is treated as receiving compensation in that amount on the date the partnership interest is transferred.

Assuming that $50,000 of taxable compensation is deemed to be the correct outcome in this example, the following entries on the partnership's tax-basis books would seem to be appropriate:

	DR	CR
Partnership asset basis (allocated 100% to Danny)	$ 10,000	
Partnership gain (allocated 100% to Danny)		$ 10,000
Compensation expense (allocated 100% to Danny)	50,000	
Thomas capital		50,000

The partnership recognizes a $10,000 gain because it effectively transferred partnership assets with FMV of $50,000 and tax basis of $40,000 to satisfy the compensation obligation owed to Thomas. In this example, the facts enforce the conclusion that Thomas actually received a capital interest rather than the stated profits-only interest, because he was able to quickly sell his interest for $50,000.

On Thomas's personal tax-basis books, the following entry would seem to be appropriate:

	DR	CR
Partnership capital	$ 50,000	
Compensation		$ 50,000

Thomas's compensation would be subject to SE tax and should be reported as such on his Form 1040.

After the transaction, Danny's tax-basis capital account would equal $120,000 ($160,000 beginning amount plus $10,000 gain minus $50,000 reduction for compensation paid to Thomas in form of partnership interest). Danny's share of tax basis in partnership assets would also be $120,000. Thomas's tax-basis capital account would be $50,000, and his share of tax basis in partnership assets would also be $50,000.

Although a payment to a partner for services is a guaranteed payment, it is unclear whether the "payment" of a partnership interest to a nonpartner (who becomes a partner after the payment is made) should be reported as a guaranteed payment on Schedule K-1 or on a Form 1099 or W-2 issued to the new partner. Because the service provider is not a partner when the agreement to perform the work is entered into, there is a position for issuing a 1099 or W-2. The Preamble to the proposed regulations on transfers of compensatory partnership interests indicates that if a substantially vested compensatory partnership interest is transferred to an employee or independent contractor [or a Section 83(b) election is made on the transfer of a substantially nonvested compensatory

partnership interest to an employee or independent contractor], the partnership reports the transfer on Form W-2 or Form 1099.

A serious problem arises when addressing the taxability of transfers of profits interests to service partners when the interest is sold within two years. It is not clear whether a sale within two years will cause the transfer of a partnership interest to a service partner to be taxable. There are many situations in which such a result would not be equitable. For instance, many types of involuntary dispositions could occur within the two-year period that would unfairly trigger tax on the transferred interest, including a technical termination of the partnership or the death or bankruptcy of the transferee partner.

It is not clear how the IRS intends to police the two-year holding requirement under Rev. Proc. 93-27. An IRS reporting requirement is anticipated at some future date that will require disclosure when a profits interest is disposed of within two years of receipt.

Example 2-6: Receiving a profits-only interest from a substantially certain and predictable stream of income in exchange for services.

Gomer and Goober are equal partners in The Mayberry Company, a general partnership. Mayberry's only source of income is from net leases on several buildings in Mount Pilot. All of these leases have a remaining term of 10 years. Yearly income (and cash flow) from the leases totals $50,000. Opie is offered a 5% profits-only interest in the partnership to keep the books and collect the lease payments.

In this situation, the net lease income produces a substantially certain and predictable stream of income. Therefore, Opie will be taxed at the time of receipt of the profits-only interest. The revenue procedure does not provide any guidance on how the interest should be valued; however, it will probably be determined based on the present value of the income stream.

Assuming a discount factor of 10%, Opie's profits-only interest in The Mayberry Company will be valued as follows:

Partnership's yearly income	$ 50,000
Percentage of partnership's cash flow from Opie's profits-only interest	× 5%
Opie's yearly cash flow	$ 2,500
Factor for the present value of an ordinary annuity for 10 years with a 10% discount	× 6.1446
The value of Opie's profits-only interest	$ 15,362

To avoid the recognition of income at the time of receiving the profits-only interest, the arrangement could be structured to be subject to a risk of forfeiture. However, the transferee partner might not be in favor of such an arrangement. Another option would be a deferred incentive management fee with the amount based on the performance of the partnership. This is essentially equivalent to a profits-only interest in a partnership.

Although this revenue procedure gives helpful guidelines on determining whether the receipt of a profits interest is taxable, uncertainty still exists in many situations. For example, the rules provide that the interest must be received in a partner capacity or in anticipation of becoming a partner, but what if the interest is received in the transferee's capacity as an employee or a nonpartner? Will the rules of the revenue procedure still apply? No guidance exists to date on whether such transactions will be taxed under the rules of the revenue procedure. A practitioner's best bet is to structure transfers to employees or partners performing professional services for a partnership (other than in a partner capacity) in such a manner that the transfers would be tax-free under the Section 83 rules.

Problems may arise if the profits interest awarded reduces the profits interest of only one partner or if the service provider is an employee. In such cases, the IRS may successfully argue that a partnership interest was not transferred. In Ltr. Rul. 9533008, a taxpayer who received an interest in a corporate partner's future share of partnership profits was deemed to receive compensation that was ordinary income to the service provider and a compensation deduction to the partner whose interest was decreased.

Rev. Proc. 2001-43 clarifies Rev. Proc. 93-27 by providing that the determination of whether an interest granted to a service provider is a profits interest is tested when the interest is granted (not when it vests), even if it is

substantially nonvested. For Rev. Proc. 2001-43 to apply, the service provider must be treated as the owner of the interest from the date of grant and must take into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing income tax liability. Further, on the grant of the interest or when the interest becomes substantially vested, neither the partnership nor any of the partners may deduct any amount as wages, as compensation, or otherwise for the fair market value of the interest. Taxpayers to which this revenue procedure applies do not need to file an election under IRC Sec. 83(b). Ltr. Rul. 200329001 confirms that service providers who meet all of the requirements of Rev. Proc. 2001-43 may avoid income recognition on both the receipt and the vesting of a profits interest even with the absence of a Section 83(b) election.

Interesting questions arise when analyzing how to book the transfer of a partnership interest to a service partner. How and when is the basis of a partnership interest received in exchange for services recovered by the service partner? The service partner recognizes income when the profits-only interest is received as compensation. The partner then recognizes the income again when the profits are actually earned by the partnership. However, no provision exists for the service partner to recover his original basis in the partnership interest until the interest is sold or liquidated.

What happens if the partnership incorporates within two years of receipt of the profits interest? Rev. Proc. 93-27 references the *disposition* of a partnership interest. The incorporation of a partnership under IRC Sec. 351 is generally a nontaxable event and the partner continues to hold an interest in the resulting entity. Therefore, it is believed that generally this should not be considered a disposition under Rev. Proc. 93-27 triggering a taxable event.

If the partner must report income because of a subsequent transfer of the interest, it would follow that the partnership could amend its return to report compensation expense in the same amount. However, the partnership would also have to report the *sale* of the transferred interest and in most cases would be required to report gain on the *sale*.

The transfer of a profits-only interest is not a capital transfer and therefore has no impact on the partnership's books. Recognizing income upon receipt of the partnership profits-only interest gives the partner an outside basis that differs from his inside basis of zero. This difference cannot be reconciled by a Section 754 election. As a result, the service partner will not be able to recover his basis in the partnership interest until the interest is sold or liquidated.

Determining If Self-employment Tax Applies to Partnership Interests Acquired for Services

If a person receives a partnership interest in exchange for services provided in connection with a trade or business and that person is not an employee of the partnership, the value of the interest is self-employment income subject to self-employment tax (IRC Secs. 1401 and 1402). The self-employment income is recognized at the same time the compensation income is recognized for income tax purposes.

Proposed Rules for Transfers of Partnership Interests for Services

In May 2005, the IRS issued Notice 2005-43 (which comes in the form of a proposed revenue procedure) and a batch of proposed regulations that together address the taxation of partnership interests exchanged for the performance of services. These proposed guidelines will not become effective unless and until they are issued as final rules. Until then, they are still instructive because they provide useful knowledge about how the IRS views compensatory transfers of partnership interests.

The proposed rules generally provide that the amount the recipient of a partnership interest reports as taxable income and the amount of the corresponding tax deduction available to the partnership is the FMV of the transferred interest. Importantly, however, the proposed rules also provide a set of taxpayer-friendly safe harbor rules for determining the FMV of compensatory partnership interests.

If and when the guidance in Notice 2005-43 is issued in the form of an official revenue procedure, it will obsolete Rev. Proc. 93-27 and Rev. Proc. 2001-43. Until then, however, taxpayers cannot rely on the safe harbor rules in Notice 2005-43. Instead, they should continue to rely on current law, including Rev. Proc. 93-27 and Rev. Proc. 2001-43.

Partner or Nonpartner Status of Service Provider

Prop. Reg. 1.761-1(b) provides that if a partnership interest is transferred in connection with the performance of services, and that interest is substantially nonvested, the holder of the interest is not treated as a partner solely by reason of holding the interest, unless the holder makes a Section 83(b) election.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Pursuant to applicable regulations, which of the following generally would constitute a substantial risk of forfeiture?

    a. A requirement that the property be returned if the recipient is discharged for cause or for committing a crime.

    b. A requirement that the property be returned if the recipient accepts a job with a competing firm.

    c. A requirement that the recipient obtain a professional designation to receive unrestricted access to the property.

    d. A requirement that the property be returned if a retiring recipient does not perform consulting services upon the request of his or her former partnership.

33. Which of the following generally does **not** constitute a substantial risk of forfeiture?

    a. A nonlapse restriction placed on the property

    b. A requirement of future performance (or lack of performance) of substantive services by the recipient.

    c. A requirement that the recipient attain a specific position within the company.

34. Bob and Jillian formed a general partnership to acquire and operate a gym. Bob contributed $500,000 for a 50% partnership interest. Jillian will contribute services in acquiring and operating the gym in exchange for an unrestricted 50% partnership interest. After the partnership was formed, it purchased an existing fitness club for $1.5 million by paying $300,000 down and obtaining a $1.2 million mortgage. The interest Jillian received constitutes property consisting of the rights granted to her under the partnership agreement. Jillian's receipt of the interest is not subject to restriction. Assuming the partnership's net worth and the FMV are equal, how much must Jillian report as gross income in the year she receives the partnership interest?

    a. $0.

    b. $250,000.

    c. $500,000.

    d. $750,000.

35. Allpro Partnership owns a storage facility with a $250,000 basis and a $400,000 FMV. Ernie has managed the business for many years. On his 20th anniversary as an employee, Allpro admits Ernie as a partner, giving him a one-fourth profits interest including any gain subsequently realized on the sale of the building in exchange for his services to continue managing the business. The partnership agreement indicates that Ernie has no right upon withdrawal from Allpro to share in the partnership assets other than in the income earned but not distributed after his admission or assets acquired with that income. What type of interest does Ernie have in the partnership?

    a. Profits interest.

    b. Capital interest.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. Pursuant to applicable regulations, which of the following generally would constitute a substantial risk of forfeiture? **(Page 287)**

    a. A requirement that the property be returned if the recipient is discharged for cause or for committing a crime. [This answer is incorrect. A requirement that the property be returned due to the fact that the recipient is discharged for cause or for committing a crime generally does *not* constitute a substantial risk of forfeiture.]

    b. A requirement that the property be returned if the recipient accepts a job with a competing firm. [This answer is incorrect. If the recipient of property accepts a job with a competing firm, a requirement that the property be returned generally does *not* constitute a substantial risk of forfeiture.]

    c. A requirement that the recipient obtain a professional designation to receive unrestricted access to the property. [This answer is correct. A requirement that the recipient obtain a professional designation or complete an advanced educational degree to receive unrestricted access to the property would likely be a substantial risk of forfeiture until either of those conditions were met.]

    d. A requirement that the property be returned if a retiring recipient does not perform consulting services upon the request of his or her former partnership. [This answer is incorrect. A requirement that the property be returned if a retiring recipient does not perform consulting services upon the request of his or her former partnership generally does not constitute a substantial risk of forfeiture.]

33. Which of the following generally does **not** constitute a substantial risk of forfeiture? **(Page 287)**

    a. A nonlapse restriction placed on the property. [This answer is correct. A nonlapse restriction placed on the property generally does not constitute a substantial risk of forfeiture. An example of a nonlapse restriction is a restriction that requires the recipient to relinquish the property if he or she leaves the partnership.]

    b. A requirement of future performance (or lack of performance) of substantive services by the recipient. [This answer is incorrect. A requirement of future performance (or lack of performance) of substantive services by the recipient does subject property to a substantial risk of forfeiture.]

    c. A requirement that the recipient attain a specific position within the company. [This answer is incorrect. A requirement that the recipient attain a specific position within the company is a purpose of the transfer of property that is subject to a substantial risk of forfeiture.]

34. Bob and Jillian formed a general partnership to acquire and operate a gym. Bob contributed $500,000 for a 50% partnership interest. Jillian will contribute services in acquiring and operating the gym in exchange for an unrestricted 50% partnership interest. After the partnership was formed, it purchased an existing fitness club for $1.5 million by paying $300,000 down and obtaining a $1.2 million mortgage. The interest Jillian received constitutes property consisting of the rights granted to her under the partnership agreement. Jillian's receipt of the interest is not subject to restriction. Assuming the partnership's net worth and the FMV are equal, how much must Jillian report as gross income in the year she receives the partnership interest? **(Page 290)**

    a. $0. [This answer is incorrect. Under the regulations, the receipt of an interest in partnership capital is a taxable event if the interest is transferred to a partner as compensation for services.]

    b. $250,000. [This answer is correct. $250,000 represents the FMV of the partnership interest Jillian received. She paid nothing for the interest, but must include the full $250,000 value in gross income as compensation in the year in which she receives the partnership interest since her receipt of the interest is not subject to restriction.]

c. $500,000 [This answer is incorrect. $500,000 is the entire FMV of the partnership. Jillian did not receive 100% of the partnership.]

d. $750,000. [This answer is incorrect. $750,000 is half of the purchase cost of the fitness club. This amount does not affect the value of Jillian's partnership interest.]

35. Allpro Partnership owns a storage facility with a $250,000 basis and a $400,000 FMV. Ernie has managed the business for many years. On his 20th anniversary as an employee, Allpro admits Ernie as a partner, giving him a one-fourth profits interest including any gain subsequently realized on the sale of the building in exchange for his services to continue managing the business. The partnership agreement indicates that Ernie has no right upon withdrawal from Allpro to share in the partnership assets other than in the income earned but not distributed after his admission or assets acquired with that income. What type of interest does Ernie have in the partnership? **(Page 291)**

a. Profits interest. [This answer is correct. Ernie has acquired a profits-only interest since he is not entitled to share in partnership assets upon withdrawal from the partnership or upon its liquidation. If the building is sold while he is a partner, the appreciation that occurred both before and after his admission would be part of the partnership's profits in which he would share.]

b. Capital interest. [This answer is incorrect. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at FMV and then the proceeds were distributed in a complete liquidation of the partnership. If the partnership agreement had allowed Ernie to share in the appreciation of the building whether or not he withdraws from the partnership, the interest would have been considered a capital interest.]

HOW TO ELECT TAXATION UPON RECEIPT OF RESTRICTED PROPERTY

A person who receives property subject to a substantial risk of forfeiture in connection with the performance of services can (a) report the income when the property becomes vested or (b) elect within 30 days of the receipt to report the property as income in the year of receipt. If this election is made, the service provider is treated as a partner for income tax purposes and is taxed at the time of receipt on the excess of the FMV of the property over the amount, if any, paid for the property.

The electing recipient receives a basis in his partnership interest equal to the sum of the compensation income recognized plus the amount, if any, paid for the interest. This basis is used to determine any subsequent gain or loss upon disposition of the partnership interest. If a Section 83(b) election is made, the service provider is treated as the owner of the interest and is taxed upon receipt as if the interest were not subject to any substantial risk of forfeiture. The later lapse or satisfaction of the condition giving rise to the risk is not a taxable event.

Understanding the Benefits of a Section 83(b) Election

The benefits of electing to be taxed in the year of receipt are twofold: (a) the recipient avoids recognizing subsequent appreciation in the partnership interest as compensation income when the interest becomes vested; and (b) any amounts received as partnership distributions are not recharacterized as compensation—the service partner is treated as a partner when allocating partnership income and loss.

When a person receives a partnership interest in exchange for services, and the person's full rights in the interest are subject to a substantial risk of forfeiture, a Section 83(b) election may be especially beneficial in two circumstances: (a) when full value is paid for the interest or the difference between the value of the interest and the amount, if any, paid for the interest is relatively small at the time of receipt; or (b) when the value is likely to appreciate greatly prior to the lapse of the risk of forfeiture.

The practitioner should always advise a partner to make a Section 83(b) election if the partner contributes full value for the interest but the interest is subject to forfeiture. A failure to make the election in such an instance causes the partner to be treated as a nonpartner, with any distributions taxed as compensation when received and with any appreciation taxed as ordinary income when the interest becomes fully vested. The failure to make a Section 83(b) election in these circumstances can create a tax cost when an indefinite deferral of income is possible with a Section 83(b) election.

Understanding the Risks of Making a Section 83(b) Election

While a Section 83(b) election may be beneficial, practitioners should be aware of a potentially significant risk that may be involved in making the election. If the value of the interest when the election is made exceeds the amount paid for the interest by the service partner, the election guarantees that compensation income will be recognized even if the interest is subsequently forfeited.

Forfeiture of Interest—Effect on Partner. If the interest is forfeited while it remains substantially nonvested, the forfeiture is treated as a sale or exchange on which the service partner may realize a loss. However, the loss is limited to the extent of the excess, if any, of the amount paid for the property by the service provider over the amount received on forfeiture. Because a partnership interest is generally a capital asset, the loss is usually a capital loss. No loss or deduction is permitted with respect to the compensation income previously recognized by the service provider. In addition, after a transfer in contemplation of a forfeiture, the service provider's loss is determined as if a forfeiture had occurred. The bottom line is that the service provider's loss is limited to his cash-out-of-pocket loss only.

Forfeiture of Interest—Effect on Partnership. If a partnership interest received in exchange for services is later forfeited by the partner, the partnership must include the amount of the prior deduction or increase in basis in gross income. Any gains or losses the partnership had previously reported in connection with the deemed taxable exchange of assets related to the services received will be recovered through depreciation or reduction of gain (or increase of loss) when such assets are sold or otherwise disposed.

Knowing How to Make a Section 83(b) Election

A Section 83(b) election must be made no later than 30 days after the date on which the property is transferred and may be made prior to the transfer date. The written election is separately filed with the IRS office where the service provider regularly files income tax returns. The service provider also attaches a copy of the election to his income tax return for the year of the transfer and furnishes a copy to the person for whom services are performed.

Example 2-7: Contributing services without making a Section 83(b) election.

On May 1, 2010, Tom, Dick, and Harry formed No Trump Tower Partnership to construct and operate an office building. Tom and Dick each contributed half interests in a lot with a total value of $600,000 for their one-third partnership interests. Harry agreed to contribute services in supervising the construction of the building for the remaining one-third interest. Tom and Dick, however, want assurance that Harry will perform as agreed. To this end, the partners agree that Harry will forfeit his partnership interest if he fails to perform the agreed-upon services through the completion of construction, unless the failure is caused by his death or disability.

The building is expected to be completed on April 15, 2011, at which time Harry's interest will vest. At that time, the partners expect the FMV of the land, building, and related property to be $8 million and the property to be subject to a $6.5 million mortgage.

Without a Section 83(b) election, Harry is taxed as having received the partnership interest when construction of the building is completed and the risk of forfeiture lapses. At that time, Harry recognizes compensation income of $500,000—one-third of the $1.5 million equity of the partnership. The partnership also recognizes gain on the transfer of capital. Income, loss, and distributions during the interim are taxed as if Harry is not a partner (as indicated in Example 2-1). Moreover, because No Trump Tower's expense relates to the construction of the building, it is capital in nature and is not deductible. Because the expense must be capitalized, the other partners bear a tax cost, at least in terms of timing, because of the late vesting of the interest.

Example 2-8: Electing to be taxed immediately upon receipt of a conditional partnership interest in exchange for services.

Assuming the same facts as in Example 2-7, if Harry makes a Section 83(b) election, he recognizes $200,000 (1/3 of $600,000) of compensation income on May 1, 2010, and is treated thereafter as a partner for tax purposes. Harry defers recognizing income from the $300,000 increase in the value of his share of the partnership's property until he transfers his partnership interest or the partnership transfers its assets. If the value were to decline after the vesting date, some of the value at the time of vesting might never be taxed.

In addition, No Trump Tower avoids gain on the hypothetical transfer to Harry of an interest in its appreciated assets (see Example 2-9). By making the election, however, Harry recognizes $200,000 of income on which he pays tax. He also assumes the risk of having neither the property nor a tax loss if he subsequently forfeits the interest.

The practitioner in the preceding examples should inform Harry of the availability of the election to accelerate the recognition of income and its advantages and disadvantages. In determining whether Harry should make the election, the practitioner should consider the following factors:

a. How certain is Harry that he will be able to meet the conditions for vesting?

b. How much income will Harry recognize immediately if he makes the election?

c. Is the expected increase in the value of the partnership interest, from the time of receipt to the time the risk of forfeiture has lapsed, substantial?

d. Considering the time value of money, how beneficial is the tax deferral?

e. Does Harry have the cash to pay the tax if he elects to accelerate the timing of the income?

In this case, the expected increase in value is substantial—$300,000. The vesting period is less than a year and, therefore, Harry should be able to meet the vesting conditions. Also, since the vesting occurs in only one year the

time value of the deferral obtained if the election is not made would be small, whereas the tax deferral from recognizing income of $200,000 in 2010, rather than $500,000 in 2011, would be substantial.

Assume instead that (a) Tom and Dick each contributed $400,000 (instead of $300,000) and agreed to guarantee any loans required by No Trump Tower, and (b) Harry, instead of receiving his one-third interest for services only, also contributed $400,000 but is obligated to sell his interest at his cost to the partnership or to Tom and Dick if he fails to perform the agreed-upon services through the completion of construction. Under these circumstances, if Harry does not make a Section 83(b) election and performs services through the completion of construction, the restriction lapses and Harry becomes the owner of the interest for tax purposes. At that time, the value of his interest in the partnership is $500,000. As a result, Harry recognizes compensation income of $100,000, the difference between the FMV of the interest at the time the condition lapses and the $400,000 he paid for the interest. Harry is required to recognize this income even though he paid full FMV for the partnership interest at the time the partnership was formed (*Lawrence J. Alves*).

In a situation such as this, the practitioner should always recommend that the taxpayer make a Section 83(b) election, because making the election involves no tax cost or risk and could provide a potentially significant tax benefit (the indefinite deferral of tax on the appreciation of the partnership interest). As the amount paid for the property and its FMV at the time of receipt were identical, the taxpayer recognizes no compensation income when he makes the election. However, by making the election, the taxpayer defers recognizing income from appreciation occurring prior to the vesting date until either he transfers his partnership interest or the partnership sells the building.

Based on a conversation with the IRS, where a partner contributes cash to a partnership and also receives an interest for services, the two can be bifurcated for purposes of qualifying under Rev. Proc. 2001-43 and Ltr. Rul. 200329001.

Revoking an Election

A Section 83(b) election can only be revoked under specific circumstances and with the consent of the IRS. Rev. Proc. 2006-31 provides guidance on obtaining such IRS consent. In order for consent to be granted, the taxpayer must (1) demonstrate that the election was made under a mistake of fact with respect to the underlying transaction, and (2) request revocation of the election within 60 days of discovering the mistake of fact. However, if the taxpayer requests a revocation before the filing deadline for the Section 83(b) election, the revocation request will generally be granted regardless of the reason for the request.

Rev. Proc. 2006-31 clarifies that a "mistake of fact" means an unconscious ignorance of a fact that is material to the underlying transaction. In other words, the electing taxpayer must have understood the facts to be other than they actually were. In addition, the mistake of fact must relate to the very essence of the underlying transaction. A mistake of fact does not include (1) ignorance of the law or an erroneous legal conclusion; (2) a mistake regarding the value of the property for which the election was made; or (3) a failure of anyone to perform an act that was expected to be performed when the property subject to the election was transferred.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Which of the following actions results from a partner's failure to make a Section 83(b) election if the partner contributes full value for the interest, but the interest is subject to forfeiture?

    a. The partner continues to be treated as a partner.

    b. Distributions are never taxed as compensation.

    c. Appreciation is never taxed as ordinary income.

    d. A tax cost can be created.

37. On June 1, 2010, Bob, Ted, and Andy formed BTA Partnership to construct and operate an office building. Bob and Ted each contributed half interests in a lot with a total value of $300,000 for their one-third partnership interests. Andy agreed to contribute services in overseeing the construction of the building for the remaining one-third interest. Bob and Ted want Andy to commit to perform as he agreed to. As such, the partners agree that Andy will forfeit his partnership interest if he fails to perform the agreed-upon services through the completion of construction, unless the failure is caused by his disability or death. The building is estimated to be competed on May 15, 2011, at which time Adam's interest will vest. At that time, the partners expect the FMV of the land, building, and related property to be $4 million and the property to be subject to a $3.25 million mortgage. Absent a Section 83(b) election, Andy is taxed as having received the partnership interest when construction of the building is completed and the risk of forfeiture lapses. At that time, how much compensation income does Andy recognize?

    a. $150,000.

    b. $250,000.

    c. $300,000.

    d. $750,000.

38. Assuming the same facts as the question above, if Andy makes a Section 83(b) election he recognizes how much compensation income on June 1, 2010?

    a. $100,000.

    b. $150,000.

    c. $300,000.

    d. $750,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

36. Which of the following actions results from a partner's failure to make a Section 83(b) election if the partner contributes full value for the interest, but the interest is subject to forfeiture? **(Page 300)**

    a. The partner continues to be treated as a partner. [This answer is incorrect. If the partner contributes full value for the interest and the interest is subject to forfeiture but the partner fails to make a Section 83(b) election, the partner will be treated as a nonpartner.]

    b. Distributions are not taxed as compensation. [This answer is incorrect. If the partner contributes full value for the interest but the interest is subject to forfeiture and the partner does not make a Section 83(b) election, distributions are taxed as compensation when received.]

    c. Appreciation is not taxed as ordinary income. [This answer is incorrect. Any appreciation is taxed as ordinary income when interest becomes fully vested if the partner fails to make a Section 83(b) election when contributing full value for the interest and the interest is subject to forfeiture.]

    d. A tax cost can be created. [This answer is correct. Instead of an indefinite deferral of income made possible with a Section 83(b) election, distributions will be taxable compensation and fully vested appreciation will be ordinary income.]

37. On June 1, 2010, Bob, Ted, and Andy formed BTA Partnership to construct and operate an office building. Bob and Ted each contributed half interests in a lot with a total value of $300,000 for their one-third partnership interests. Andy agreed to contribute services in overseeing the construction of the building for the remaining one-third interest. Bob and Ted want Andy to commit to perform as he agreed to. As such, the partners agree that Andy will forfeit his partnership interest if he fails to perform the agreed-upon services through the completion of construction, unless the failure is caused by his disability or death. The building is estimated to be competed on May 15, 2011, at which time Adam's interest will vest. At that time, the partners expect the FMV of the land, building, and related property to be $4 million and the property to be subject to a $3.25 million mortgage. Absent a Section 83(b) election, Andy is taxed as having received the partnership interest when construction of the building is completed and the risk of forfeiture lapses. At that time, how much compensation income does Andy recognize? **(Page 300)**

    a. $150,000. [This answer is incorrect. $1500,000 is the amount that Bob and Ted each contributed in a lot for their one-third partnership interests.]

    b. $250,000. [This answer is correct. Andy recognizes compensation income of $250,000, his one-third share of the $750,000 million equity of the partnership.]

    c. $300,000. [This answer is incorrect. $300,000 is the total combined amount that Bob and Ted contributed in a lot for their combined one-third partnership interest.]

    d. $750,000. [This answer is incorrect. $750,000 is the total amount of equity Bob, Ted, and Andy have in the partnership.]

38. Assuming the same facts as the question above, if Andy makes a Section 83(b) election he recognizes how much compensation income on June 1, 2010? **(Page 300)**

    a. $100,000. [This answer is correct. If Andy makes a Section 83(b) election, he recognizes $100,000 of compensation income on June 1, 2010, one-third of $300,000.]

    b. $150,000. [This answer is incorrect. Andy defers recognizing income from the $150,000 increase in the value of his share of the partnership's property until he transfers his partnership interest or the partnership transfers its assets.]

    c. $300,000. [This answer is incorrect. $300,000 is the total compensation income of the partnership on June 1, 2010.]

    d. $750,000. [This answer is incorrect. $750,000 is the total equity of the partnership.]

RULES COVERING PARTNERSHIP INTERESTS ACQUIRED IN EXCHANGE FOR SERVICES

The following discussion addresses the rules that currently govern the receipt of a partnership interest in exchange for services. Practitioners should be aware that proposed regulations and Notice 2005-43 provide new rules and new safe harbor provisions that will apply to the receipt of a partnership interest by a service partner when the regulations are finalized.

The issue of value is always important when IRC Sec. 83 applies to a transfer of property— including a partnership interest transfer to a service partner. Indeed, the problem of valuation is especially tricky when the property is a partnership interest because a ready market seldom exists to help establish value.

Valuing Capital Interests

If the transferred partnership interest is a capital interest, the liquidation value is often assumed to establish the interest's FMV. While this is certainly a convenient rule of thumb and may often establish an appropriate value consistent with the overall tax treatment of the transaction (see Example 2-9), practitioners may have room to argue for a lesser value—because of lack of liquidity, transfer restrictions, and other factors. Such factors are certainly considered in other contexts when property is valued.

The time at which the interest is valued may be an issue. The Tax Court found that the taxpayer (the general partner in a limited partnership) had to recognize taxable income when he received a 1% interest in partnership capital. The 1% interest was shifted from the limited partners to the general partner and was described as compensation in partnership documents. The proper time for valuing the 1% interest was determined to be when all limited partners were on board, rather than at an earlier date when the partnership had been legally formed but not yet fully capitalized.

Analyzing the Effect of Nonlapse Restrictions and Minority Ownership

A *nonlapse restriction* is a restriction on the property which, by its terms, will never lapse and which allows the transferee to sell only at a price fixed pursuant to a formula (e.g., book value or a percentage of gross revenues). In such cases, the price determined by taking into account the nonlapse provision will be the property's FMV for Section 83 purposes. A later cancellation of the restriction, however, can generate taxable income.

While nonlapse restrictions are common when stock is transferred to employees, the practitioner considering using a nonlapse restriction in connection with the transfer of a partnership interest must be careful. The restriction will almost certainly be considered part of the partnership agreement and could affect the viability of partnership allocations under the substantial economic effect test.

Another factor that commonly affects the reported value of a transferred interest is a minority discount. A minority discount is most typically used when interests are transferred as part of an estate plan, but has equal validity in valuing any transferred interest. Generally, a minority discount reflects the minority status, lack of control, and limited marketability of a minority interest in the partnership. (In Rev. Rul. 93-12, the IRS agreed that minority discounts could apply even in a situation where other family members control the entity.) The courts have held that any discount must be supported by the facts of the specific case.

In the case of a transferred partnership interest the IRS may throw out a minority discount and require valuation based on the liquidation value of the partnership interest, since some state statutes provide for the partnership's termination upon the withdrawal of a partner. In such cases, the value of the transferred interest will be the FMV of the partner's proportionate share of the partnership's assets. Practitioners concerned about the inability to use discounts because of a partner's right to withdraw and receive payment for the partner's interest should consider recommending that the partnership be formed in a more restrictive state.

Valuing Profits Interests

Most tax practitioners consider a profits-only interest in a partnership to have little or no present value. This concept is based on using a liquidation value approach to value the profits interest. According to the liquidation value approach, the profits-only partnership interest has little (or no) value because:

- The service partner has no initial interest in partnership capital—if the partnership is liquidated on the date the interest is transferred, the partner receives none of the liquidation proceeds.
- The future allocation of profits to the service partner is impossible to value, since such profits are contingent on a number of uncertainties.

Under the provisions of Rev. Proc. 93-27, the receipt of a profits interest for services rendered by a partner is taxable in three separate situations. The valuation required in each situation is as follows:

a. If the profits interest relates to a substantially certain and predictable income stream, the value of the interest will probably be the present value of the income stream. (See Example 2-6.)

b. If the profits interest received is disposed of within two years of receipt, the value will probably be determined at the time of disposition and equal the value on the disposition date. (See Example 2-5.)

c. If the profits interest is an interest in a publicly traded partnership, the value will probably be the market value of similar interests.

Valuing an Interest Received for Services as Income in Respect of a Decedent

If a taxpayer dies before receiving a partnership capital interest for services rendered prior to his death, his successor in interest will recognize the FMV of the interest as income in respect of a decedent (IRD) under IRC Sec. 691. Although not stated in the regulations, it seems reasonable to treat a profits interest the same way.

If the interest was subject to any restrictions and was not substantially vested at the time of the partner's death, the practitioner should review IRC Sec. 83 when implementing the IRD rules. In most cases, the substantial risk of forfeiture terminates or is breached when a partner dies. If the substantial risk does lapse, causing it to vest when the partner dies, the income should be reported on the decedent's final individual income tax return. Any restrictions on the partnership interest that do not lapse at the time of the decedent's death should affect the valuation of the partnership interest in the decedent's estate tax return.

Safe Harbor Rules for Valuing Transferred Interests Under Proposed Regulations

Prop. Reg. 1.83-3(l) provides that a partnership that qualifies as a safe harbor partnership and all of its partners can elect to follow a set of safe harbor valuation rules for purposes of determining the FMV of compensatory partnership interests. However, until the proposed regulations are finalized, they are not effective.

Under these taxpayer-friendly rules, the FMV of a partnership interest transferred in connection with the performance of services is deemed to be equal to the liquidation value of that interest. Liquidation value means the amount of cash that the recipient of the compensatory partnership interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the FMV of those assets and then liquidated.

In May 2008, a Treasury Department official indicated that the IRS is "going back to the drawing board" to rework the proposed safe harbor election for the treatment of compensatory interests. As an example of unintended consequences from application of the proposed regulations, the Treasury official noted the ability of a "maverick" partner to cause the termination of a valuation election by taking a position inconsistent with the other partners.

A safe harbor partnership interest is any interest in a partnership that is transferred to a service provider (either before or after the partnership's formation), provided the interest is not (a) related to a substantially certain and predictable stream of income from the partnership's assets (such as income from high-quality debt securities or a

high-quality net lease), (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of IRC Sec. 7704(b).

Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, the interest is presumed to be transferred in anticipation of a subsequent disposition if the interest is sold or disposed of within two years of the date of its receipt (other than a sale or disposition by reason of death or disability of the service provider).

The elective safe harbor valuation rules apply when the following conditions are satisfied:

a. The partnership must prepare a document (executed by a partner who has responsibility for federal income tax reporting) stating that the partnership is electing (on behalf of the partnership and each of its partners) to have the safe harbor valuation rules apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect. The election must specify the effective date of the election, which cannot be prior to the date the election is executed. The election must be attached to the partnership's Form 1065 for the tax year that includes the effective date of the election.

b. The partnership agreement must contain provisions that are legally binding on all of the partners stating that (1) the partnership is authorized and directed to elect the safe harbor rules, and (2) the partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor rules with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. If an amendment to the partnership agreement is required, it must be effective before the date on which a transfer occurs in order for the safe harbor rules to apply.

c. If the partnership agreement does not contain the provisions described in item b (or the provisions are not legally binding on all partners), each partner must execute a document containing provisions that are legally binding on that partner stating that (1) the partnership is authorized and directed to elect the safe harbor valuation rules, and (2) the partner agrees to comply with all requirements of the safe harbor rules with respect to all partnership interests transferred in connection with the performance of services while the election remains effective. The document must be effective before the date on which a transfer occurs for the safe harbor rules to apply.

d. The partnership must retain the records necessary to indicate that an effective election has been made and remains in effect.

In remarks to the Practicing Law Institute conference on May 17, 2007, a senior counsel to the Treasury Department indicated that it is important that all the partners agree to the safe harbor treatment under the proposed regulations and comply with that treatment. He also indicated that a partnership interest subject to a purchase or sale within two years would be outside the safe harbor.

Vested versus Nonvested Partnership Interests. Under the safe harbor valuation rules, a partnership interest is treated as substantially vested if the right to the associated capital account balance equivalent is not subject to a substantial risk of forfeiture or the interest is transferable. An interest is treated as substantially nonvested only if, under the terms of the interest at the time of the transfer, the interest terminates and the holder may be required to forfeit the capital account balance equivalent that is credited to the holder under conditions that would constitute a substantial risk of forfeiture, and the interest is not transferable. If the service provider receives a partnership interest that is substantially nonvested, does not make a Section 83(b) election, and holds the interest until it substantially vests, the service provider recognizes compensation income in an amount equal to the liquidation value of the interest on the date the interest substantially vests, less any amount paid for the interest.

Impact of Section 83(b) Election. If the service provider receives a partnership interest that is substantially nonvested and makes a Section 83(b) election, the service provider recognizes compensation income on the date of transfer equal to the liquidation value of the interest, determined as if the interest were substantially vested, less any amount paid for the interest. Under IRC Sec. 83(h), the partnership is generally entitled to a deduction equal to the amount included as compensation income by the service provider.

Forfeiture of Compensatory Interests

Prop. Reg. 1.704-1(b)(4)(xii) provides detailed rules that address what happens when a Section 83(b) election is made and the affected partnership interest is subsequently forfeited. The rules cover the partnership and the person who makes the Section 83(b) election and later forfeits the partnership interest.

Collective Impact of Proposed Rules

The impact of the proposed compensatory partnership interest transfer rules can be illustrated by following them using the facts in Example 2-5. Assuming that $50,000 of taxable compensation is deemed to be the appropriate outcome in that example, the following entry on the partnership's tax-basis books would seem to be appropriate under the proposed rules:

	DR	CR
Guaranteed payment expense (allocated 100% to Danny)	$ 50,000	
Thomas Capital		$ 50,000

On Thomas's personal tax-basis books, the following entry would seem to be appropriate.

	DR	CR
Partnership Capital	$ 50,000	
Guaranteed payment income		$ 50,000

Thomas's guaranteed payment income would be subject to SE tax and should be reported as such on his Form 1040.

As seen here, the big difference between the outcome under the existing rules (shown in Example 2-5 and the outcome under the proposed new rules (shown in the preceding paragraph) is that no partnership-level gain or loss is triggered by the compensatory transfer of the partnership interest. Typically, the outcome under the proposed rules will be preferable to the partners.

TAX CONSEQUENCES TO THE PARTNERSHIP

Under IRC Sec. 83, the person or entity for whom the services are provided (the partnership) is treated as having paid for the services with the transferred property. The payment is considered made when the recipient recognizes income. This payment has two consequences:

a. The transfer of the property is treated as a taxable exchange.

b. The partnership incurs either compensation expenses or a capital expenditure equal to the value of the transferred interest.

Treating the Transfer as a Taxable Exchange

As previously noted, the transfer of property from the partnership to the service partner is treated as a taxable exchange. The transferor partnership recognizes gain or loss based on the difference between the FMV of the property and the partnership's basis.

While service-related transfers of property are treated as taxable dispositions of the property, neither the Code nor the regulations indicate how to view such a transfer when the transferred property is an interest in the transferor partnership. The partnership could be viewed as having transferred an intangible asset in which it has no basis, i.e., the partnership interest. Alternatively, the partnership could be viewed as having transferred an undivided interest in all of its assets, followed immediately by a recontribution of the property by the new partner in exchange for his partnership interest.

Example 2-9: Determining the partnership's gain or loss from granting a capital interest in exchange for services.

On January 1, 2010, in consideration for past and future management services, Thomas was admitted to the Stucco Estates Partnership and given a 10% capital and profits interest that was not subject to any restrictions. The interests of Marvin and Ray, the original 50/50 partners, were each reduced to 45%. On January 1, 2010, the partnership had the following assets and no liabilities:

Assets	Adjusted Basis	FMV
Land	$ 50,000	$ 60,000
Building	275,000	330,000
Personal property	25,000	40,000
Marketable securities	30,000	20,000
Total	$ 380,000	$ 450,000

If Stucco Estates had liquidated on the date Thomas was admitted, he would have received $45,000. Assuming the FMV of his interest in Stucco Estates is equal to this $45,000 liquidation value, Thomas has $45,000 of compensation on January 1, 2010, the date the capital shift occurred. (See Example 2-2.)

If the existing partners each had transferred 5% of their 50% interests to Thomas, and a Section 754 election had been made by Stucco Estates, Stucco Estates would be taxed as if it had transferred a 10% interest in each of its assets to Thomas for consideration equal to the FMV of each such interest. The taxation of the transaction would be as follows:

Assets	Partnership's Basis	FMV	Partnership's Gain (Loss)
Land	$ 5,000	$ 6,000	$ 1,000
Building	27,500	33,000	5,500
Personal property	2,500	4,000	1,500
Marketable securities	3,000	2,000	(1,000)
Total	$ 38,000	$ 45,000	$ 7,000

The gains and losses must be computed on an asset-by-asset basis and may have different characters. Since the gains and losses are not aggregated or netted, the gain allocable to the building might be depreciation recapture, while the loss allocable to the securities would be a capital loss.

This hypothetical asset transfer is taxed as if it occurred immediately before admitting Thomas as a partner. Consequently, the gains and losses should be allocable only to Marvin and Ray. To make this result certain, however, the practitioner should suggest that the partners amend their partnership agreement to specifically provide for such an allocation.

The hypothetical asset transfer would also change the partnership's basis in those assets. The practitioner might suggest that the partners specifically allocate future tax items to take into account these changes. The allocations would work in much the same manner as if Thomas had purchased his interests from Marvin and Ray and a Section 754 election had been made, or as if the partnership distributed a prorata share of the assets to all partners who then contributed their interests in partnership capital at the same time. [It may be that IRC Sec. 704(c) will be applied to require this result, but a special allocation will ensure it.] With such an allocation, all gain or loss on subsequent transactions, to the extent that it represented appreciation or depreciation inherent in the assets at the time Thomas became a partner, would be taxed to Marvin and Ray. The deemed contribution also may give rise to special capital account adjustments. See Example 2-11 for discussion of the treatment of the partnership's expenditure for Thomas's services.

Example 2-10: Determining the partnership's tax consequences from granting a profits interest in exchange for services.

Danny and Thomas formed a general partnership to develop land Danny owned that had a $200,000 FMV and a $160,000 basis. Danny's book capital account was credited with $200,000, and he received a 50% partnership interest. Thomas agrees to contribute services in developing the land for the remaining 50% interest in partnership profits. Thomas's book capital account had an initial balance of zero. Danny and Thomas did not stipulate the value of Thomas's profits-only interest at the time it was obtained.

Thomas will not recognize income on the receipt of his profits interest since he does not fall within one of the exceptions outlined in Rev. Proc. 93-27. Since he does not recognize any income, the partnership is not deemed to have *sold* any assets and cannot deduct any compensation expense with regard to the transfer.

However, if Thomas sells his interest within two years of receipt, he must amend his income tax return for the year of receipt to report compensation income. If such a sale occurs, presumably the partnership will recognize gain or loss on the share of partnership assets deemed transferred to Thomas, and will be able to deduct compensation expense equal to the income reported by Thomas. The partnership would need to amend its return to deduct the compensation expense.

Treating a Transfer as an Expense or Capital Expenditure

The partnership transferring the property in exchange for services incurs compensation expense. This expense is either deductible or capitalizable depending on the nature of the services provided. (See Example 2-11.) (Note that Rev. Proc. 2001-43 provides that neither the partnership nor any of the partners may deduct any amount as wages, as compensation, or otherwise for the FMV of a profits interest granted to a service provider and covered by the provisions of the revenue procedure—either at the time the interest is granted or when the interest becomes substantially vested.)

When a service provider recognizes income because of the receipt of property, the person for whom the services were provided generally deducts the payment as an expense in the year in which the income is includable in the service provider's gross income. However, this expense must be capitalized if the expense is capital in nature.

In the past, if the service provider was an employee of the person for whom services were provided, regulations permitted a deduction only if the employer deducted and withheld federal income tax (but apparently not FICA) from the compensation income. Amendments to the regulations were issued to eliminate this special rule as a prerequisite for claiming a deduction for property transferred to an employee in connection with the performance of services. It is believed that this issue should not be relevant to the receipt of a partnership interest in exchange for a contribution of services to the partnership, since a partner is not an *employee* of the partnership (Rev. Rul. 69-184). Upon receipt of the interest, which is the taxable event, the service provider becomes a partner, even if he was previously an employee.

Reg. 1.721-1(b)(2) characterizes the transfer of a capital interest as a guaranteed payment. This characterization should probably be ignored for most purposes since the provisions of IRC Sec. 83 dictate results that are not consistent with that treatment. However, the characterization of the transfer as a guaranteed payment does support the position that the withholding requirement is not applicable, since a recipient of a guaranteed payment must be a partner. There is another point of view that a *payment* of a partnership interest to a nonpartner (who becomes a partner after the payment is made) should be reported on Form 1099.

The proposed regulations retain the notion that the issuance of a partnership interest for services is a deemed guaranteed payment but state that the Section 83 timing rules apply to the partnership for deduction purposes (instead of the guaranteed payment timing rules).

Therefore, the partnership's deduction is claimed in the partnership tax year that includes the end of the recipient partner's tax year in which the deemed payment is included in that partner's income under that partner's method of accounting. In other words, the timing of the partnership's deduction is controlled by the timing of the partner's income instead of the other way around.

The preceding deduction timing rule in the proposed regulations recognizes that it's not always possible to reconcile the partnership rules with the Section 83 rules. The proposed regulations provide guidance for the timing of the partnership deduction but will not become effective until they are finalized.

The character of the compensation payment (ordinary or capital) is based on the facts and circumstances. If there is a question as to the nature of the expense, the practitioner may be able to help the partners support the desired treatment. For example, the position that the payment is for a deductible expense can be substantiated by an advance written statement of the specific nature of the services for which the partnership interest is granted. Although the statement is self-serving, if the partners act in a manner consistent with that statement, they increase the likelihood of sustaining the desired treatment.

Prop. Reg. 1.721-1(b)(1) states that IRC Sec. 721 (the general rule providing for no taxable gain or loss upon a contribution by a partner to a partnership in exchange for an interest) generally does not apply to the transfer of an interest in connection with the performance of services. Instead, such a compensatory transfer constitutes a transaction under IRC Sec. 83. Under the Section 83 rules, the recipient of a partnership interest received for services is generally taxed on the FMV of the interest [IRC Sec. 83(a)]. In general, however, the proposed rules provide that no taxable gain or loss is recognized by the partnership upon (a) the transfer or substantial vesting of a compensatory partnership interest, or (b) the forfeiture of such a partnership interest (due to failure to meet the vesting requirements). The proposed regulations will not become effective until they are finalized.

Allocating the Expense or Basis Increase to the Proper Partners

The practitioner should also focus on another issue—which partners are entitled to benefit from the partnership's compensation expense deduction (or basis increase, if applicable). One opinion is that the tax benefits of these items should be allocated automatically to the individuals who were partners immediately prior to the service partner's admission because the costs were incurred then [IRC Sec. 706(d)]. Nevertheless, the practitioner should advise the partners to specifically provide for such an allocation in the partnership agreement.

IRC Sec. 706(d)(1) provides that when there is a change in a partner's interest in the partnership during the year, the partnership can use the closing of the books method, the proration method, or any other reasonable method to take into account the varying interests of the partners for purposes of allocating partnership tax items. However, IRC Sec. 706(d)(2) classifies payments for services by a partnership that uses the cash method of accounting as allocable cash basis items that must be allocated using the proration method.

Prop. Reg. 1.706-3(a) overrides the preceding rule by stating that transfers of partnership interests in connection with the performance of services are not allocable cash basis items. Therefore, the partnership can use the closing of the books method, the proration method, or any other reasonable method to account for changes in the interests of the partners triggered by compensatory transfers of partnership interests. However, taxpayers should be aware that the proposed regulations will not become effective until they are finalized. Until then, they provide useful knowledge about how the IRS views this area.

If the existing partners wish to make losses available to the incoming service partner to offset compensation income, the partners should amend their partnership agreement to allocate other, post-admission partnership losses to the service partner in a manner consistent with the Code's requirements. Any such decision, however, should be made only after considering all aspects of the transaction—the service partner's compensation income, the partnership's compensation expense, and any partnership gain or loss on the transaction.

Example 2-11: Deducting compensation expense upon granting a capital interest in exchange for services.

Assume the same facts as in Example 2-9. Can Stucco Estates deduct the compensation recognized by Thomas upon his receipt of an interest in exchange for services?

Thomas's services were related to the management of the partnership's building. As such, they were not capital in nature. Consequently, Stucco Estates is entitled to a $45,000 deduction for compensation expense (expensed as a guaranteed payment), the amount Thomas recognized as compensation income. (See Example 2-9.) If Thomas's services had related both to building management and to the property acquisition,

a portion of the total expense would be capitalized as part of the cost of acquiring the assets. The partnership could obtain a tax benefit from the capitalized portion of the expense only by depreciating the building or by adding the capitalized expense to the tax basis used to determine gain (or loss) on disposition.

EVALUATING THE EFFECT ON BOOK AND TAX BASIS CAPITAL ACCOUNTS

The admission of a partner upon a contribution of services must be recorded in both the book (or economic) and tax basis capital accounts of the partnership. The bookkeeping for the service partner's *contribution* and the partnership's *expense* will vary depending on the type of partnership interest transferred (capital or profits-only) and the classification of the expenditure by the partnership (capital expenditure or deductible expense).

Reg. 1.704-1(b)(2)(iv)(f)(5)(iii) permits partner's capital accounts to reflect a revaluation of partnership property in regards to the grant of a partnership interest (other than a *de minimis* interest) in exchange for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner. This change facilitates the granting of profits-only interests in exchange for services by permitting adjustments to the capital accounts of the other partners (those not receiving interests for services) to reflect changes in the value of partnership assets. Immediately after such a revaluation, the capital account associated with the profits-only interest would have an initial book value of zero (the desired outcome).

Capital Account Treatment

Prop. Reg. 1.704-1(b)(2)(iv)(b)(1) provides that a partner's book capital account includes the amount deemed to be contributed by that partner to the partnership as a result of receiving a partnership interest in exchange for services. Under this rule, the amount included in the partner's capital account equals the compensation income recognized under IRC Sec. 83(a), (b), or (d)(2). The proposed regulations will not become effective until they are finalized.

The preceding proposed rule effectively allows the partner's book capital account to be increased by the deemed guaranteed payment triggered by the receipt of the compensatory partnership interest. Ordinarily, the partnership tax rules provide that a guaranteed payment has no impact on the recipient partner's capital account. However, this "standard" treatment does not work when a deemed guaranteed payment does not involve any direct transfer of assets from the partnership to the recipient partner, as is the case with a compensatory transfer of a partnership interest.

Transferring a Capital Interest

Since a partner who receives an interest in partnership capital in exchange for services would immediately receive a right to the proceeds of a partnership liquidation, the service partner's book capital account should be credited with his proportionate share of the net FMV of partnership assets. For example, a 10% capital interest in a partnership with total assets of $100,000 and no liabilities would result in a book capital account balance of $10,000. The service partner's tax basis capital account should be credited with his proportionate share of the tax basis of partnership assets.

Transferring a Profits-only Interest

The transfer of a profits-only interest is not a transfer of capital and as such has no impact on the book or tax basis capital accounts of the partnership, unless the election to revalue is made. While this makes obvious sense in the case where an interest in future profits is transferred (and the partner is not taxed on the receipt of the interest in future profits), it is difficult to apply this same rationale to a service partner receiving an interest in fixed assets or receivables previously reported in partnership income or to a service partner receiving an interest in preexisting built-in appreciation of fixed assets or receivables not yet reported in partnership income. In either of these situations, it appears that the service partner has actually received an interest in partnership capital rather than an interest in partnership profits and should record the transfer in the same manner as the transfer of a capital interest discussed previously.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. The receipt of a profits interest for services rendered by a partner is taxable in three distinct circumstances. Which of the following situations and the valuation required is accurate?

    a. If the profits interest relates to a generally uncertain income stream, the value of the interest will probably be the average value of the income stream.

    b. If the profits interest received is disposed of within three years of receipt, the value will probably be determined at the time of disposition and equal the value on the disposition date.

    c. If the profits interest is an interest in a publicly traded partnership, the value will probably be the market value of similar interests.

    d. If the profits interest is an interest in a privately held partnership, the value will probably be based on the partnerships' most recent tax return.

40. Under IRC Sec. 83, the partnership is treated as having paid for the services provided with the transferred property. The payment is considered made when the recipient recognizes income. Of the following, which one is **not** a consequence of this payment?

    a. The transfer of the property is treated as a nontaxable exchange.

    b. The partnership incurs compensation expenses.

    c. A capital expenditure equal to the value of the transferred interest is incurred by the partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

39. The receipt of a profits interest for services rendered by a partner is taxable in three distinct circumstances. Which of the following situations and the valuation required is accurate? **(Page 306)**

    a. If the profits interest relates to a generally uncertain income stream, the value of the interest will probably be the average value of the income stream. [This answer is incorrect. If the profits interest relates to a *substantially certain and predictable* income stream, the value of the interest will likely be the *present* value of the income stream.]

    b. If the profits interest received is disposed of within three years of receipt, the value will probably be determined at the time of disposition and equal the value on the disposition date. [This answer is incorrect. The value will probably be determined at the time of disposition and be equal to the value on the disposition date if the profits interest received is disposed of within *two* years of receipt.]

    c. If the profits interest is an interest in a publicly traded partnership, the value will probably be the market value of similar interests. [This answer is correct. Under Rev. Proc. 93-27, the value of the interest will probably be the market value of similar interests if the profits interest is an interest in a publicly traded partnership.]

    d. If the profits interest is an interest in a privately held partnership, the value will probably be based on the partnerships' most recent tax return. [This answer is incorrect. If the profits interest is an interest in a privately held partnership, this situation is not one of the three separate situations where the receipt of a profits interest for services rendered by a partner is taxable under the provision of Rev. Proc. 93-27.]

40. Under IRC Sec. 83, the partnership is treated as having paid for the services provided with the transferred property. The payment is considered made when the recipient recognizes income. Of the following, which one is **not** a consequence of this payment? **(Page 308)**

    a. The transfer of the property is treated as a nontaxable exchange. [This answer is correct. One consequence of this payment is that the transfer of the property is treated as a *taxable* exchange, not a nontaxable one.]

    b. The partnership incurs compensation expenses. [This answer is incorrect. One consequence of the payment for services with transferred property is that the partnership may incur compensation expenses.]

    c. A capital expenditure equal to the value of the transferred interest is incurred by the partnership. [This answer is incorrect. One consequence of the partnership paying for services with transferred property may be that the partnership incurs a capital expenditure equal to the value of the transferred interest.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (TPSTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

33. Amounts deferred under a nonqualified deferred compensation plan for all tax years are currently includable in gross income to the point that they are not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met, as provided for in IRC Sec. 409A. If the provisions of IRC Sec. 409A are not met by the taxpayer, the taxpayer may be subject to an acceleration of income recognition and a penalty equal to _____ of the compensation required to be included in gross income and interest on the deferred amounts.

    a. 10%.

    b. 20%.

    c. 25%.

    d. 30%

34. Under IRC Sec. 83, any person receiving unrestricted property in connection with the performance of services:

    a. Recognizes taxable income immediately.

    b. Recognizes taxable income within 30 days of receipt of the property.

    c. Recognizes taxable income in the tax year the property is received.

    d. Does not recognize taxable income on the receipt of the property.

35. Bobby and Melissa formed a general partnership to acquire and operate a storage facility. Bobby contributed $200,000 for a 75% partnership interest. Melissa will contribute services in acquiring and operating the storage facility in exchange for an unrestricted 25% partnership interest. After the partnership was formed, it purchased an existing storage facility for $800,000 by paying $160,000 down and obtaining a $640,000 mortgage. The interest Melissa received constitutes property consisting of the rights granted to her under the partnership agreement. Melissa's receipt of the interest is not subject to restriction. Assuming the partnership's net worth and the FMV are equal, how much must Melissa report as gross income in the year she receives the partnership interest?

    a. $0.

    b. $50,000.

    c. $66,667.

    d. $250,000.

36. An individual who receives property that is subject to a substantial risk of forfeiture related to the performance of services has two options. He or she can report the income when the property becomes vested, or elect within ______ of the receipt to report the property as income in the year of receipt.

    a. 30 days.

    b. 45 days.

    c. 60 days.

    d. 90 days.

37. Which of the following statements does **not** reflect the effect on the service partner if interest is forfeited while it remains substantially nonvested?

    a. The service partner may realize a loss.

    b. The loss is usually a capital loss.

    c. No loss is permitted on compensation income previously recognized by the service provider.

    d. The service provider's loss generally exceeds his cash-out-of-pocket loss.

38. A Section 83(b) election can only be revoked under specific conditions and with the consent of the IRS. For consent to be granted, the taxpayer must show that the election was made under a mistake of fact regarding the underlying transaction and make such a request within 60 days of discovering the mistake of fact. In accordance with Rev. Proc. 2006-31, what is a "mistake of fact?"

    a. The electing taxpayer must have understood the facts to be other than they actually were and relate to the meaning of the underlying transaction.

    b. The electing taxpayer was ignorant of the law pertaining to a Section 83(b) election.

    c. There was a failure of anyone to perform an act expected to be performed when the property subject to the election was transferred.

    d. The electing taxpayer made a mistake regarding the value of the property for which the election was made.

39. The courts have held that the taxpayer, the general partner in a limited partnership, must recognize taxable income when he or she received a ____ interest in partnership capital in exchange for services.

    a. ½%.

    b. 1%.

    c. 1½%.

    d. 2%.

40. Under proposed regulations concerning safe harbor rules for valuing transferred interests, a safe harbor partnership interest is any interest in a partnership that is transferred to a service provider before or after the formation of the partnership, provided the interest meets certain criteria. Which choice below is one of the criterion?

    a. The interest is related to a substantially certain and predictable stream of income derived from the partnership's assets.

    b. The interest is transferred in anticipation of a subsequent disposition.

    c. The interest is not an interest in a publicly traded partnership within the meaning of IRC Sec. 7704(b).

    d. Do not select this answer choice.

GLOSSARY

At-risk: The amount a partner has at risk in the partnership. This amount is the basis for the deductibility of partnership losses by the partner.

Basis: The amount used by the taxpayer to compute the amount of gain or loss upon sale or disposition of an asset.

De minimis rule: Under U.S. tax rules, the de minimis rule governs the treatment of small amounts of market discount. Under the de minimis rule, if a bond is purchased with a small amount of market discount (an amount less than 0.25 percent of the face value of a bond times the number of complete years between the bond's acquisition date and its maturity date) the market discount is considered to be zero. If the market discount is less than the de minimis amount, the discount on the bond is generally treated as a capital gain upon disposition or redemption rather than as ordinary income.

Derivative financial instruments: Instruments whose value is derived from the value of something else. The main types of derivatives are futures, forwards, options, and swaps.

Disguised sale rules: Under disguised sale rules, the Internal Revenue Code allows a partner to withdraw assets from a partnership (in a non-liquidating distribution) without recognition of income to the extent of the partner's basis in the partnership interest.

Family limited partnership: A family partnership is a noncorporate entity created by the transfer of property from one or more individuals to the entity for the common economic benefit of family members.

Futures contract: A standardized contract, traded on a futures exchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price.

Guaranteed payments: Amounts partners receive for services they provide to the partnership are guaranteed payments (if the amounts are determined without regard to partnership net income). The costs of several of the most common types of fringe benefits provided to partners are treated as guaranteed payments (assuming they are provided regardless of partnership income and for services rendered in the partner's capacity as a partner).

General partnership: A *general partnership* is an association of two or more persons or entities to carry on as co-owners a business for profit. A *general partnership* is formed when two or more persons or entities enter into an agreement to carry on a trade or business with a sharing of the profits and losses between the partners. All partners in a general partnership are referred to as *general partners*. All of the general partners are jointly and severally personally liable for the debts and obligations of the partnership, unlike a limited partnership, where not all partners are personally liable.

Joint venture: An enterprise participated in by associates acting together, with a community of interests, each associate having the right to participate in its management. For income tax purposes, a joint venture is treated as a partnership, not taxable in its own capacity, but regarded as a taxpayer for the purpose of computing its taxable income, which is distributable among the associates in the proportions agreed upon. Such distributive shares are reported by the associates on their individual income tax returns.

Large partnerships: Large partnerships have at least $10 million of total assets or adjusted assets, or $35 million in gross receipts.

Letter of intent: A letter of intent (LOI) is a document outlining an agreement between two or more parties before the agreement is finalized.

Limited liability company (LLC): A limited liability company (LLC) is a form of business organization created by statute which is a separate legal entity from its owners and has attributes of both a *corporation* and a *partnership.* A principal benefit of the LLC format is *limited liability* for its members and managers, so that such persons are not personally liable for the debts and obligations of the entity, similar to a *corporation.* Another principal benefit of the LLC format, when properly formed and organized, is that the LLC does not incur tax liability at the entity level; it is a *pass-through entity.* The members of the LLC recognize the tax consequences, similar to a *partnership.*

Limited liability partnership (LLP): This type of entity is similar in many respects to the LLC. All states currently have an LLP statute. LLPs arose in response to the personal liability problems faced by partners in law and accounting partnerships. In most states, the limited liability protection afforded to LLP partners and LLC members is the same. However, in some states, LLP partners remain personally liable for the commercial and other general obligations of the partnership, and for their own errors and omissions and the errors and omissions of persons under their supervision.

Limited partner: A limited partner is a party who is merely an investor in a partnership. The party's liability is limited to the capital contribution to the partnership. Like a corporate shareholder, a limited partner does not participate in the management of the business.

Limited partnership: A limited partnership is a partnership created by statute (not common law) consisting of at least one general partner and one or more special or limited partners. It is regulated by the Uniform Limited Partnership Act (ULPA) in most states.

Organization costs: Otherwise capitalizable costs incurred in the formation of the partnership (including legal fees, filing fees, and related costs).

Partner: A partner is an individual, estate, trust, corporation, or other entity that owns a capital or profits interest in a partnership.

Partner interest expense: One of the six classifications of interest expense found in the Internal Revenue Code. This type of interest expense passes through as a separately stated item to the partners who then determine the nature of the expense at the partner level.

Partner loan: A partner's amount at risk is increased by the amount of any loans made by the partner to the partnership to the extent the partner's basis in his partnership interest would be increased under IRC Sec. 752.

Partnership: A partnership is an association of two or more persons to carry on as co-owners a business for profit. Partnerships are governed in the various states of the United States by the Uniform Partnership Act. A partnership may be a general partnership, a limited partnership, LLC, or a joint venture.

Partnership agreement: A partnership is usually created as a result of an agreement between the prospective partners. This agreement, including any amendments, can be oral or written. Amendments must be made prior to the due date (including extensions) of the partnership's tax return. If the partnership agreement is silent on any matter, applicable provisions of local law are considered to be part of the agreement.

Publicly traded partnership (PTP): A general or limited partnership is a PTP if the partnership interests are traded on an established securities market, or are readily tradable in a secondary market or equivalent.

Safe harbor: A safe harbor is a provision of a statute or a regulation that reduces or eliminates a party's liability under the law, on the condition that the party performed its actions in good faith.

S corporation: A tax status election for corporations that meet the specified requirements under which they are taxed as a partnership (i.e., income passes through to the owners, who are then taxed on their share of the corporate earnings on their personal income tax returns). S corporations do not pay the corporate income tax, and corporate losses can be claimed by the shareholders, subject to the basis and passive loss rules. The requirements are located in subchapter S of the Internal Revenue Code (IRC).

Technical termination: A partnership terminates under the tax laws (i.e., a technical termination) if a 50% or greater interest in its capital and profits is sold or exchanged within a 12-month period.

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Companion to PPC's Tax Planning Guide—Partnerships—Course 1—Partnership Status and Organization (TPSTG101)

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8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

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2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit trainingcpe.thomson.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Tax Planning Guide—Partnerships— Course 3—Contributions of Property & Services (TPSTG103)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   TPSTG103 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **April 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

Page

CPE Examination Questions (Lesson 1) **277**

CPE Examination Questions (Lesson 2) **315**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Tax Planning Guide—Partnerships—Course 3—Contributions of Property & Services (TPSTG103)

CTEC Course No. 3039-CE-0250
Price $79

First Name: ____________________

Last Name: ____________________

Firm Name: ____________________

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Express Grading Requested: ☐ Add $24.95

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: April 30, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Tax Planning Guide—Partnerships—Course 3—Contributions of Property & Services

Course Acronym: TPSTG103

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
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