Partnerships

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Overview

PROLOGUE

This Market Segment Specialization Program (MSSP) Guide is designed to assist examiners in classifying and examining partnership returns. The focus is on issues that fall within sections 701 through 761 of the Code (Subchapter K). Subchapter K deals primarily with the formation, operation, and termination of partnerships. Many issues arise during the initial or final year of the partnership.

If your return relates to an operating business (as opposed to rentals), you should also look for an MSSP Guide for that type of business.

The Tax Equity and Fiscal Responsibility Act of 1982 created the "TEFRA Entity." Returns qualifying as TEFRA Partnerships and their partners are subject to these "unified procedures" which are contained in IRC sections 6221-6234. The procedures are briefly explained in Chapter 13.

DEFINITION AND FORMATION

IRC section 761(a) defines a partnership as any organization through or by means of which any business, financial operation, or venture is carried on which is not a corporation, trust or estate.

A partnership is formed when two or more "persons" agree to carry on a joint venture. A written agreement, although preferred, is not required. State law now generally requires that a partnership have a written agreement. Partnership agreements should cover initial capital contributions, required services, life of the partnership and other important items. Such agreements must always be inspected when examining a partnership return.

Pre-opening expenses must be capitalized just as with any other business. In addition, certain expenses of organizing the partnership must also be capitalized (see Initial Year Return Issues, Chapter 1).

Where a partnership is engaged in an investment activity (not a trade or business), or where used for the joint extraction, production or use of property, a partnership can elect out of the provisions of Subchapter K. For example, if two brothers own a parcel of land and farm it, it is a partnership; if they each take their share of the crop, and expenses, they can elect out of Subchapter K.

PARTNERSHIP ENTITIES

Partnerships, like corporations, are creatures of the State, whose laws provide for their creation, operation and liquidation. Initially, all partnerships were "General Partnerships" where each and every partner was jointly and severally liable for all partnership debts. For example, Lloyds of London is a group of syndicates engaged in the insurance business. Recently, many of the investors were surprised to discover that they were general partners subject to liabilities from claims of environmental damages and the like.

Because of the dangers of unlimited liability, it became difficult to find investors for joint ventures. This resulted in the creation of Limited Partnerships under state statutes where a class of partners who were not active in the business but were merely investors, could receive limited liability for partnership debts and actions. Under these Uniform Partnership laws, professionals could not be limited partners since they were "active" in the business. This meant that partners engaged in law, medicine, or accounting could not have limited liability and each partner was jointly and severally liable for the errors, omissions, and malpractice of any partner. As a result of pressure from these groups, states enacted statutes to provide for Limited Liability Company's (LLC's) and Limited Liability Partnerships (LLP's). Using these entities, professional partners can now use a partnership form and not be liable for the "sins" of other partners; they would still be completely liable for their own malpractice. As a result of these state law changes, the Service issued regulations providing that these entities would be taxed as partnerships unless they elected to be taxed as a corporation by checking a box on Form 8832 and attaching it to their initial return (the "Check-the-Box Regulations"). These entities are partnerships for tax purposes, but see Self-Employment Tax in Chapter 12.

Note that a single member LLC is generally a sole proprietorship if the member is an individual. In the case of a corporation or partnership owning a single member LLC, the LLC is considered a "Division" and is not required to file a return if the income and expenses are reported on the return of the member.

OPERATIONS

During the operating years of a partnership, the tax issues are generally the same as a corporation or sole proprietorship. The amount of income determined at the partnership level and allocated to the partners according to the partnership agreement must be reported whether or not there are any cash distributions. Income allocated disproportionately among the partners may be adjusted on examination if the allocation was done solely for tax purposes and does not reflect economic reality. Partnership losses are passed through to partners, whether general or limited partners, and are allowed to the extent of the partner's basis in their partnership interest. It is important to remember that a partner's share of liabilities is included in the calculation of their basis in their partnership interest. When inspecting a partner's Schedule K-1, it may be disconcerting to see that the partner has a negative capital account; that is, the partner has deducted losses in excess of their cash investment. This occurs because the capital account does not include the partner's

share of liabilities. If the amount of liabilities allocated to the partner (shown on Schedule K-1 just above the ending capital account) is not greater than the capital account, the partner's losses should be limited. In addition to basis limitations, partnership losses are subject to limitations for "at-risk" basis and passive losses. See Loss Limitations.

LIQUIDATION/TERMINATION

Care must be taken to ensure that any negative capital account is reported in income in the year of liquidation. Although partners are happy to include liabilities in basis during the operating years in order to deduct losses, they frequently forget to include those liabilities in the amount realized on the disposition of their interest. Since the partner is "deemed" to be relieved of liabilities on the disposition of his partnership interest, even a gift or charitable contribution of a partnership interest will result in a gain where the capital account was negative. Sometimes the final partnership return will show that some partners have negative capital accounts and others are positive-the total of the ending capital accounts being zero. The regulations require that final year income be allocated to those with negative capital accounts until they reach zero such that all ending capital accounts are zero.

ENTITY VERSUS AGGREGATE

There is a basic tension between the "Entity" and "Aggregate" Theories of partnership accounting for tax purposes. Under the Entity Theory, the amount and character of partnership income is determined at the partnership level as though it was an entity separate from its partners. This includes elections such as accounting method and other initial year elections. According to the Aggregate Theory, each partner is treated as the owner of a direct and undivided interest in partnership assets, liabilities and operations. Tax is actually paid at the partner level. For tax rules that provide separate elections or limitations, such as IRC section 108 cancellation of debt (COD) income exclusions, itemized deductions, and tax preferences, partners are treated as a group of individual sole proprietorships.

The Service and the Courts have struggled at times to try to determine which concept should apply in different circumstances. Many tax shelters, including Abusive Corporate Tax Shelters rely on the Entity Theory to determine the character or allocation of income; they use (or abuse) subchapter K to achieve a result that could not occur without a partnership cloak. If you believe the partnership you are examining is a tax shelter carefully review the Tax Shelter chapter.

Another example of these separate approaches is IRC section 179, depreciation; Congress specified that the $17,500 limitation would apply at the partnership level (Entity) and that the partner would also be subject separately to the limitation (Aggregate). That is, the partner's share from the partnership would be added to any IRC section 179 depreciation the partner had from other businesses in computing the limitation, even though it had already been limited at the partnership level.

With increased filings of partnership returns, this area of tax law has taken on increased importance. Although this guide is not all-inclusive, we hope that it will serve the needs of the examiners in the field.

Chapter 1

Initial Year Return Issues

INTRODUCTION

In the initial year of a partnership, several Code sections limit or preclude a current deduction for costs incurred prior to the actual operation of a business.

This chapter deals with three specific types of expenses:

- Organizational Expenses
- Syndication Expenses
- Start Up Expenses.

Other issues covered in this chapter include the tax implications of payments made to partners:

- IRC section 707(a) ─ Partner or Non-Partner
- Receipt of a Capital or Profits Interest
- Payments Capitalized, Deducted, or Distributed?
- Guaranteed Payments

ISSUE: INITIAL YEAR EXPENSES

Under prior law, organization, syndication, and start up costs were not deductible. Through a series of litigation, it became firmly established that these were capital costs and were recovered as a part of the partner's basis on disposal of the partnership interest. Subsequently, Congress enacted IRC section 709 and IRC section 195, which provide guidance for these expenses.

Section 709 ─ Organization and Syndication Expenses

Applicable after 1975, IRC section 709 provides for the tax treatment of the costs of organizing a partnership and promoting the sale of a partnership interest.

Under IRC section 709(a) a current deduction is not allowed for the cost of organizing a partnership and promoting the sale of partnership interests.

Subsequently, IRC section 709(b) provides that organization expenses may be amortized over a period of not less than 60 months. The partnership must capitalize these costs and timely elect the 60 month rule. The partnership is not allowed to elect amortization treatment after the return has been filed, such as during the audit process.

Syndication expenses are not included in IRC section 709(b). They cannot be deducted or amortized.

Syndication Costs

These are the costs of syndicating a partnership and its related investment units. Syndication costs are normally items incurred for the packaging of the investment unit (the partnership unit), and the promotion of it. These include marketing costs as well as the production of any offering memorandums or promotional materials. Included is the training of any brokers/dealers who will sell the partnership units, plus the actual sales commissions paid to the sellers of the partnership (whether they are unrelated third parties or the individuals who promoted the investment). Other costs normally incurred as a part of syndication could include legal costs associated with the offering, tax opinions, due diligence, costs of transferring assets to the partnership, printing and preparation of offerings/prospectus, etc.

Organization Costs

Organization costs include the legal and accounting costs necessary to organize the partnership, facilitate the filings of the necessary legal documents, and other regulatory paperwork required at the state and national levels.

There is a fine line which exists between syndication costs and organization costs. Generally, syndication represents those costs associated with the sale of the actual investment units, while organization costs are those costs necessary to legally create the partnership.

Election to Amortize Organization Expenses

The election to amortize organization expenses is made on the return for the year in which business commenced. It is made by completing Part VI of Form 4562, Depreciation and Amortization. A separate statement must be attached to the return containing the following information:

- A description of each cost
- The amount of each cost (costs of less than $10 may be aggregated)
- The month the active business began, (or the month the business was acquired)
- The number of months in the amortization period (not less than 60).

An amended return cannot be filed to subsequently ***elect*** amortization of organization expenses. However, an amended return can be filed, including ***additional*** organization expenses, when a timely election has previously been made.

IRC section 195 - Start-Up Expenditures

IRC section 195(a), added in 1980, denies a deduction for start-up costs.

IRC section 195(b) however, specifically allows the taxpayer to elect to treat these costs as deferred expenses and amortize them over a period of not less than 60 months.

IRC section 195(c) provides the definition of the terms "start-up costs" and "beginning of trade or business".

Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit or for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or business. The expenditures must be of such a nature that they would be deductible if they had been incurred in the operation of an existing business.

When an active trade or business is purchased, start-up costs include only costs incurred in the course of the general search for or preliminary investigation of the business. Costs incurred in the attempt to actually purchase a specific business are capital expenses and are not amortizable under IRC section 195.

Investigatory expenses are those incurred in the review of a prospective business before a decision to acquire the business has been made. See Revenue Ruling 99-23 for a definition of allowable investigatory expenses.

Start-up expenses and pre-opening expenses include costs incurred after a decision has been made to acquire or enter into a business. These would include salaries and wages for training employees, travel for obtaining prospective distributors, suppliers, or customers. Generally this term is given to expenses that would be deductible currently if they had been incurred after actual business operations had begun.

Expenses specifically <u>not</u> included in start-up costs are those costs allowable under IRC section 163(a), interest expense; IRC section 164, taxes; or IRC section 174, research and experimental costs.

Election to Amortize Start Up Expenses

The election to amortize start up expenses must be made no later than the due date of the return (including extensions). It is made by completing Part VI of Form 4562. A separate statement must be attached to the return containing the following information:

- A description of the business to which the start-up costs relate
- A description of each start-up cost incurred
- The month the active business began, (or the month the business was acquired)
- The number of months in the amortization period (not less than 60).

If a revised statement is required, it cannot include any costs treated on a return as other than a start up cost. Accordingly, the only costs that can be added to the original statement are costs incurred in a subsequent year that are added to the total start up costs to be amortized. An amended return cannot be filed to reclassify costs to start up costs.

Cash Basis Taxpayers and Start Up Costs

A partnership using the cash basis cannot take an amortization deduction until the organization or start-up cost has been paid. If paid in a year after the business has begun, they can deduct an amount equal to the number of months beginning with the effective date of the IRC section 709(b) election. This will catch up the amount of amortization on items paid in subsequent years with the amortization on costs paid in the initial election year.

Dispositions before the End of the Amortization Period

If a business is completely disposed of before the end of the amortization period, the remaining unamortized balance of properly elected organization and start-up expense is deductible as an ordinary loss under IRC section 165. Syndication expenses paid outside the partnership by the partner, must be added to the partner's basis and will affect gain/loss on disposition or increase the basis in distributed assets on liquidation.

GAAP versus Tax Accounting - Start Up and Organization Costs

Under generally accepted accounting principles, organization costs and start up costs are expensed as incurred.

Specifically, the AICPA, in Statement of Position (SOP) 98-5 defines in broad terms what are start up costs and requires that such costs be expensed. This broad definition would include most of the expenditures that are required to be capitalized for tax purposes. Therefore, GAAP versus tax differences generally exist and should be reflected on the partnership Schedule M-1.

Payments To A Partner: IRC section 707(A) ─ Partner Or Non-Partner

IRC sections 702 and 704 provide that a partner includes in income his or her "distributive share" of partnership income or loss, and the amount of that distributive share is usually determined by the partnership agreement. IRC section 731 provides that no gain is to be recognized as a result of distributions by the partnership so long as those distributions do not exceed the partner's basis in his or her partnership interest. While these provisions represent logical and equitable approaches to the taxation of businesses operated in partnership form, they have been used by some taxpayers to circumvent capitalization requirements and to avoid reporting income.

By treating various payments to a partner as a deduction or a distribution of profits, a partnership may attempt to change the nature of a payment. Examples of these recharacterizations would include transforming capital items to deductible expense and fee income into portfolio income.

IRC section 707 (a) was enacted to prevent such potential abuses.

IRC section 707(a)

IRC section 707(a) was originally intended to prevent misuse of IRC sections 702, 704 and 731. It ***requires*** that transactions between a partnership and a partner, who is ***not*** acting in his or her capacity as a member of the partnership, to be considered as occurring between the partnership and one who is not a partner. That is, an outsider or unrelated party. IRC section 707(a)(1) can encompass loans, leases, sales, and employment relationships.

The wording of IRC section 707(a)(1) is very brief, and the regulations for this subsection provide very little explanation except to state in the last sentence of Treas. Reg. section 1.707-1(a): "In all cases, the substance of the transaction will govern rather than its form." In general, services involving a partner's particular technical expertise are considered "non-partner."

Apparently the law and regulations were not specific enough to accomplish the desired effect, so, as part of the Tax Reform Act of 1984, a second paragraph was added to IRC section 707(a) which is reflected as IRC section 707(a)(2).

The law specifically provides that payments to a partner for either services or property will be treated as a transaction between the partnership and an outsider so long as he is acting other than in his or her capacity as a member of the partnership. This forces the partnership to treat the payment as if it were paid to an unrelated third party and removes any option to treat the payment as a partner's distributive share as shown in the Examples 1 through 4 in this chapter.

Payments To A Partner: Receipt of a Capital or Profits Interest

During the course of partnership formation, it is not uncommon for the partner who is to manage the partnership's affairs to receive an interest in partnership profits in exchange for the performance of past or future services. Since it is the combination of labor and capital that creates a business, this is to be expected. Over the years, taxpayers, the Service, and the courts have struggled with the tax consequences of the many variations of these partnership agreements.

A "Bare" Profits Interest – An interest in partnership profits with no interest in partnership capital is a "bare" profits interest. Generally, the receipt of a partnership interest in exchange for services is taxable under IRC section 61(a)(1) and Treas. Reg. section 1.61-2(d)(1) as property received for services.

However, Treas. Reg. section 1.61-2(d)(6) provides an exception in the case of property subject to a restriction that has a significant effect on its fair market value under IRC section 83.

A *capital* interest in a partnership is generally not subject to a substantial risk of forfeiture under IRC section 83 and will not meet the exception. Therefore, it will be included in the income of the recipient at its fair market value (Treas. Reg. section 1.721-1(b)(1)).

Since the value of a *profits* interest is contingent on the realization of profits in the future, it is difficult to value and is generally considered to be IRC section 83 property. Under IRC section 83, at the time the profit is *determined* and added to the service partner's capital account, it is taxable to the partner and deductible by the partnership.

To provide further guidance, the Service announced in Rev. Proc. 93-27 that they would not attempt to tax the receipt of a profits interest except where the income is fairly certain, the interest is disposed of within 2 years of receipt, or it is publicly traded.

When is a Partner not a Partner? – Rev. Proc. 93-27 did not put an end to all of the controversy regarding receipt of a profits interest. The receipt of a profits interest does not automatically make one a partner. A similar agreement could be made with an independent contractor. Someone who receives a "guaranteed payment" of so much a month plus a percentage of the profits may in fact be an employee with profit -sharing.

Pursuant to Rev. Proc. 93-27, the receipt of a profits interest in exchange for future services should generally be accepted. However, if the partnership appears to be designed primarily to provide tax benefits to one or both parties, careful analysis should be applied to ensure that partner status for tax purposes is warranted.

Regulations regarding performance of services have not yet been issued, but the Section 707 Committee Reports contain significant guidance. The Committee was concerned with transactions that avoid capitalization requirements. Other concerns were situations where a service partner received a portion of partnership capital gains in lieu of a fee, the effect of which converted ordinary income into capital gain. The Committee was not concerned with non-abusive allocations that reflect the various economic contributions of the partners. The rules apply both to one- time transactions and continuing arrangements that utilize purported partnership allocations and distributions in place of direct payments.

The Committee believed that the following factors should be considered in determining if the purported allocation is received by the partner in his or her capacity as a partner.

Generally, the most important factor is whether the payment is subject to an appreciable risk as to amount. An allocation and distribution provided for a service partner which subjects the partner to significant entrepreneurial risk as to both amount and payment generally would be recognized. Other factors indicating that the payment may be a fee include:

- Transitory (temporary or short-term) partner status
- The payment is made close in time to the performance of the services
- Whether, under all the facts and circumstances, it appears that the recipient became a partner primarily to obtain tax benefits for himself or the partnership which would not have been available had the services been rendered in a third

party capacity. The fact that a partner has significant non-tax motives is of no particular significance
- The recipient's interest in continuing partnership profits is small in relation to the allocation

In applying these factors, one should be careful not to be misled by self-serving assertions in the partnership agreement, but should look to the substance of the transaction.

In cases where allocations are only partly related to the performance of services, the above provisions will apply to the portion related to services. Even where the service partner has contributed some capital, the "profits interest" may still be carved out and treated as compensation.

In ***Smith Est. et. al.*** (63-1 U.S.T.C. 9268), the Eighth Circuit Court of Appeals held that a common fund, from which the manager received a percentage of the profits from trading commodities futures, was a partnership but that the manager's share of the profits was compensation, not capital gain. To the extent that **partners of the manager** invested cash in the common fund, they were entitled to treat the income from their investment as capital gains and losses.

Payments to Partners – Payments Capitalized, Deducted, or Distributed?

Capital Item Shown as a Deduction or Distribution

In the early years of a partnership, it is common to see payments or reimbursements to partners that are properly capital in nature.

Examples are payments to partners for the following:

- Organization Expenses, IRC section 709
- Syndication Expenses, IRC section 709
- Start-up costs, IRC section 195
- Capital Assets, IRC section 263
- Uniform Capitalization Rules, IRC section 263A

Example 1-1

Assume that a broker is a 25 percent interest owner in a partnership that plans to construct a building. She provides services including packaging and promotion of the investment units, resulting in the sale of all the planned partnership units. For her services she is paid a fee of $40,000. Assume that partnership income for the year of payment amounted to $100,000 before considering the $40,000 payment to broker partner. Proper treatment of this $40,000 expenditure would be to capitalize it as a nondeductible syndication expense, with no direct effect on the partnership's total income of $100,000. Of course, the broker partner would also include the $40,000 fee in her income, probably on a Schedule C. The total effect on the partners' returns would be as follows:

	25% Partner	75% Partner	**Total**
Partnership Income	$ 25,000	$ 75,000	$ 100,000
Broker's Fee	40,000	0	40,000
Total Income Reported	$ 65,000	$ 75,000	$ 140,000

This is the proper treatment of this item. It has been shown as a payment to a person who is not a partner. This is correct under Section 707(a).

If the partnership had improperly deducted this capital expenditure, taxable income would have been reported as follows:

Example 1-2

	25% Partner	75% Partner	Total
Original Partnership Income	$25,000	$ 75,000	$100,000
Deduction for Broker's Fee	(10,000)	(30,000)	(40,000)
Net Partnership Income	$ 15,000	$ 45,000	$ 60,000
Broker's Fee	40,000	0	40,000
Total Income Reportable	$ 55,000	$ 45,000	$ 100,000

By deducting an otherwise capital expense, the partnership has effectively reduced its net ordinary taxable income by $40,000. Since we would disallow this deduction because it is a non-deductible syndication expense, the partnership may try to achieve the same result by treating the broker's fee as part of the broker's distributive share. In this case, the allocation between the partners would be slightly different, but the incorrect net taxable amount remains $100,000 as follows:

Example 1-3

	25% Partner	75% Partner	Total
Original Partnership Income	$ 25,000	$ 75,000	$ 100,000
Special Allocation	40,000	(40,000)	0
Total Income Reportable	$ 65,000	$ 35,000	$ 100,000

By treating the $ 40,000 fee as a part of the broker's distributive share, the partnership has managed to deduct an expenditure that any other taxpayer would be required to capitalize. Section 707(a) would require treatment as a payment to a person not a partner in the partnership, changing the reporting to the $140,000 result shown in Example 1-1.

Conversion of Fee Income into a Capital Gain

Another abuse that IRC section 707(a) was intended to prevent relates to the shifting of the nature of income. An example of this is the shifting of fee income to a distributive share of a partnership's capital gain, portfolio income, etc. as shown in the following example.

> **Example 1-4**
>
> Mr. A is a financial advisor. He has a contract with Investor B to manage $20 million of Investor B's assets. The contract requires Investor B to pay 20 percent of profits annually to Mr. A as a fee for managing the assets.
>
> In Year 1, the $20 million is invested and earns a total of $4 million in capital gain, dividend, and interest income. Accordingly, Mr. A earns a fee of $800,000 (20 percent of the $4 million). Mr. A reports this as income subject to employment tax. On his Form 1040, Investor B includes the $4 million in income and deducts the $800,000 fee as a miscellaneous itemized deduction subject to alternative minimum tax.
>
> In Year 2, Mr. A and Investor B form Partnership AB. Investor B contributes his $20 million in assets. Mr. A contributes no capital and receives a 20 percent profits interest in exchange for managing the assets.
>
> Assume the earnings in Year 2 are equal to Year 1 earnings.
>
> Mr. A now receives the $800,000 of income as a distributive share of partnership capital gain and portfolio income, not subject to self-employment tax. Investor B now includes $3.2 million into income ($4 million @ 80 percent).
>
> Although the economic relationship between Mr. A and Investor B has not changed, the tax treatment of their activity has changed significantly.

In general, the provisions of IRC section 707(a) would require the payment to Mr. A to be treated as paid to a non-partner. This would require the tax treatment to be reported as it was in Year 1.

Guidance on the issue of payments to service providers who receive a profits interest in a partnership is set forth in ***Luna***, 42 T.C. 1067 (1964) and includes:

1. The intent of the parties to create a partnership
2. The ability of the service provider to control the income or capital
3. Whether the parties share a mutual proprietary interest in the net profits of the venture
4. Whether the service provider has an obligation to share in losses
5. Whether the venture was conducted in the joint names of the parties
6. Whether the partners filed a partnership return
7. Whether the parties held themselves out as joint venturers
8. Whether separate books were maintained for the partnership

9. Whether the parties exercised mutual control over and assumed mutual responsibilities for the business of the partnership.

Of all of the factors enumerated in ***Luna***, the most important is entrepreneurial risk. Does the partner have the risk of loss if the venture is unsuccessful? In the example above, Mr. A has no risk of loss since he has no capital at-risk. All losses will be allocated to Investor B.

Guaranteed Payments – IRC section 707(c)

A guaranteed payment is deducted in the computation of partnership income. Accordingly, it is considered a payment made to one who is not a member of the partnership and is deducted in full, just as if it were an ordinary expense under IRC section 162. A guaranteed payment is an amount paid to a partner that is determined without regard to the partnership income and is made to a partner acting in his or her capacity as a partner. Additionally, the amount paid must be deductible under IRC section 162 as an ordinary business expense. Thus, illegal payments or payments that are capitalizable are not deductible under IRC section 707(c).

Prior to 1976 many taxpayers interpreted the law as providing that guaranteed payments were automatically deductible. In 1976 IRC section 707(c) was amended to specifically hold that if the payment is a capital expense under IRC section 263 it must be considered as made to one who is not a member of the partnership. Accordingly, it must be capitalized and is not automatically deductible. At the same time, IRC section 709 was added and it became evident that a taxpayer cannot convert organization and syndication expenses into a current deduction by casting the payment as a guaranteed payment.

It is sometimes difficult to distinguish between payments to partners which fall under IRC section 707(a)(partner not acting in capacity as partner), and those which are governed by IRC section 707(c) (guaranteed payments).

- The determining factor is whether the partner is acting other than in his or her capacity as a member of the partnership.

- Generally, if the partner performs a service for the partnership that he/she also performs for others (such as an attorney, architect, stockbroker, etc.), payments will be deducted or capitalized by the partnership under IRC section 707(a).

- However, if he or she works exclusively or primarily for the partnership, payments are more likely to be treated as guaranteed payments per IRC section 707(c) (if not based on partnership income) or as his or her distributive share under IRC section 702(a) (if based on partnership income).

Whether the payment is under IRC section 707(a) (payment to a partner not acting in his or her capacity as a partner), or under IRC section 707(c) (guaranteed payment), it <u>cannot be treated as a distribution</u> of partnership profits. Also, if it is paid for any capital item, it <u>cannot be expensed</u>.

So why even make the distinction between IRC section 707(a) and IRC section 707(c)? One of the most important reasons is the timing of receipt of income by the partner. Guaranteed payments are always includable in the partner's taxable income as of the end of the tax year in which the ***partnership*** deducts or capitalizes the payment. On the other hand, payments made under IRC section 707(a), and considered paid to a non-partner, retain their character and timing based on the nature of the payment and the accounting method of the ***partner*** as previously shown in Example 1-4.

Examination Techniques

Start up costs, organization costs, and syndication expenses of partnerships may not have been properly classified. Areas to consider during examination are:

1. Did any partners claim an itemized deduction for a legal fee, tax advice fee, surety fee, etc., incurred in connection with the partnership? If no organization or syndication costs are apparent from the records of the partnership, it may be necessary to examine the general partner or other entity that established the partnership to determine what costs were incurred. IRC section 709 states that such costs are not deductible by a partner.

2. Is there a first year management fee, or a guarantee of a set amount of profit, for the organizing partner in the early years of the partnership that is designed to compensate him/her for organization costs?

3. A detailed examination of the organizing partner's records will be required if you see any indication that syndication fees have been amortized under the guise of organization costs.

4. Partnerships often attempt to deduct large syndication payments in the year of organization that are either paid to the general partner or to outsiders and are actually capital in nature. Sales commissions, a proper IRC section 263 capital item, may be labeled as management fees, interest, or another classification that would make it appear to be a deductible expense. When the commission is substantial, it is often fractionalized into any number of classifications and amounts and spread out to appear deductible.

5. Other payments to partners may require capitalization. Examples would include certain legal, accounting, and architectural fees.

6. Partnerships with a large number of partners should have significant syndication costs on the balance sheet and a large amount of organizational expense being amortized.

7. You should note that the classification given to a payment is often misleading. Thus, a strict analysis is needed. Since the payments may require a different tax treatment, Rev. Rul. 75-214, Rev. Rul. 85-32, as well as IRC sections 195, 248 and 709 should be consulted for guidance.

8. Secure written description of duties performed by the promoter/partner. Determine what portion of promoter/partner fees is related to syndication costs, organizational costs, start-up costs, and asset acquisition. Ask the promoter/partner for contemporaneous records to verify the amount of time spent on initial activities. In instances where the taxpayer refuses to provide records, the agent should consider disallowing the entire developer fee. (***Carp & Zuckerman v. Commissioner,*** T.C. Memo. 1991-436).

9. If any partner receives an interest in the entity in exchange for services rendered, the facts must be considered to insure proper treatment. At the partnership level, this will include the determination of when and how the partnership reflects the allocation of profits and/or capital. At the partner level, it will be a determination as to the proper timing and nature of the inclusion of income by the partner receiving the interest.

Issue Identification

In the initial years of a partnership the Schedule M-1 should have entries for start-up and syndication expenses which were deducted per book and have been treated differently for tax purposes. The lack of entries here will be an initial indication that start-up and syndication expenses may have been deducted.

Additionally, inspection of the partners' returns may indicate a deduction by the partner for these items. Sometimes these costs are paid by the partner and deducted as a miscellaneous itemized deduction, etc. Therefore, review the partners' returns.

Any changes to the capital accounts may reflect items that could be subject to capitalization.

Inspection of Schedules K-1 may reflect changes to partnership interests. Analysis should reflect if any interests were provided for services rendered to the partnership.

Documents to Request

1. Partnership agreement and all amendments
2. Articles of Organization (LLC's) and all amendments
3. Private Placement Memorandum, prospectus, or any similar documents
4. Any agreements with brokers or sales agents

Interview Questions

Interview questions will vary based on the information presented and will be contingent on how clear a picture is presented, specifically:

1. Who organized the entity and how was he/she compensated?
2. Were brokers or agents used to sell partnership interests?
3. When did the business begin?
4. What expenses were incurred prior to the opening?

Supporting Law

IRC section 709
IRC section 707
IRC section 195
IRC section 263
IRC section 263A
IRC section 61
IRC section 83

Rev Rul 99-23, 1999-20 C.B. 3, provides guidance on the type of expenditures that will qualify as investigatory costs that are eligible for amortization as start-up expenditures under Section 195 when a taxpayer acquires the assets of an active trade or business.

Rev. Rul. 88-4, 1988-1 C.B. 264, states that the fee paid by a syndicated limited partnership for the tax opinion used in the partnership prospectus is a syndication expense chargeable by the partnership to a capital account and cannot be amortized.

Rev. Rul. 85-32, 1985-1 C.B. 186, states the following: Syndication costs incurred in connection with the sale of limited partnership interests are chargeable by the partnership to a capital account and cannot be amortized.

Rev. Rul. 81-153, 1981-1 C.B. 387, states the following: An investor in a limited partnership may not deduct that part of the purchase price that is paid, through a rebate or discount arrangement, by the investor to a tax advisor on behalf of the partnership for services related to the sale of the partnership interest. The partnership may not amortize this amount under IRC section 709(b). The investor's basis in the partnership is the amount of cash contributed.

In ***Carp & Zuckerman v. Commissioner***, 62 T.C.M. (CCH) 658, T.C. Memo. 1991-436, the court allowed no part of a purported development fee as the taxpayer failed to establish the purpose and nature of the expenditure.

In ***Diamond v. Commissioner***, 92 T.C. 423 (1989), guaranteed payments were made to partners which they contended were for management services. The court required the payments to be capitalized. The taxpayer did not provide a basis for estimating what portion was for management services under ***Cohan v. Commissioner***, 39 F.2d 540 (2d Cir. 1930).

In ***Collins v. Commissioner***, 53 T.C.M. (CCH) 873, T.C. Memo. 1987-259, it was found that management and consulting fees paid shortly after the formation of a general partnership were held to be organizational expenses and were required to be amortized rather than currently deducted. Similarly, legal and accounting fees incurred shortly after formation were nondeductible organization and syndication expenses.

In ***Vandenhoff v. Commissioner***, 53 T.C.M. (CCH) 271, T.C. Memo. 1987-116 and ***Isenberg v. Commissioner***, 53 T.C.M. (CCH) 946, T.C. Memo. 1987-269, it was

found that guaranteed payments by a motion picture partnership to the general partners were in the nature of syndication expenses and were required to be capitalized.

In ***Schwartz v. Commissioner***, 54 T.C.M. (CCH) 11, T.C. Memo. 1987-381, ***aff'd*** without opinion, 930 F.2d 920 (9th Cir. 1991), it was found that payments made to a partner were syndication expenses that must be capitalized and were not deductible as guaranteed payments.

In ***Driggs v. Commissioner***, 87 T.C. 759 (1986), it was found that amounts paid to a general partner as "sponsor's fees" were not deductible because the partnership failed to prove whether the expenses were for syndication fees or for organization costs.

In ***Egolf v. Commissioner***, 87 T.C. 34 (1986), it was held that a partnership could not currently deduct organization and syndication costs by indirectly paying them to a partner under the guise of management fees. Since no election was made by the partnership, no amortization of partnership organization expenses was allowed.

In ***Durkin v. Commissioner***, 87 T.C. 1329 (1986), the court ruled that payments made by a partnership to two general partners for services were for expenses in connection with organizing the partnership and the offering and such payments were not currently deductible as guaranteed payments. The partnership was entitled to amortize the expenses.

In ***Finoli v. Commissioner***, 86 T.C. 697 (1986), it was determined that amounts paid for preparation of a tax opinion, incurred to promote or facilitate the sale of partnership interests, and commissions and consulting fees constituted non-deductible syndication expenses.

In ***Tolwinsky v. Commissioner***, 86 T.C. 1009 (1986), and ***Law v. Commissioner***, 86 T.C. 1065 (1986), it was found that organizational expenses for a motion picture tax shelter were amortizable only to the extent that such expenses were substantiated.

In ***Surloff v. Commissioner***, 81 T.C. 210 (1983), it was found that fees paid to an attorney by partnerships mainly for the preparation of a tax opinion letter that was used in a prospectus given to potential investors were syndication expenses and had to be capitalized.

In ***Flowers v. Commissioner***, 80 T.C. 914 (1983), it was determined that expenditures for tax advice were incurred for purposes of obtaining the tax opinion letter that accompanied organization and sales promotion of limited partnership interests and were non-deductible capital expenditures.

In ***Wendland v. Commissioner***, 79 T.C. 355 (1982), ***aff'd***, 739 F.2d 580 (11th Cir. 1984), it was determined that legal expenses paid to a law firm by a coal mining tax shelter partnership constituted organizational expenses. These expenses had to be capitalized in the absence of evidence allocating such expenses between legal advice and tax advice.

In ***Johnsen v. Commissioner***, 83 T.C. 103 (1984), motion denied, 84 T.C. 344 (1985), ***rev'd*** on other grounds, 794 F.2d 1157 (6th Cir. 1986), it was found that a partner could not deduct his share of claimed expenses for legal and tax advice. The evidence showed that the services concerned the organization and promotion of the partnership.

In ***Smith v. Commissioner***, 33 TC 465 (1960), ***aff'd*** in part and ***rev'd*** in part, 313 F. 2d 724 (8th Cir. 1963). The Court of Appeals held that a common fund, from which the manager received a percentage of the profits from trading commodity futures, was a partnership but that the manager's share of the profits was compensation, not capital gain. To the extent that partners of the manager invested cash in the common fund, they were entitled to treat the income from their investment as capital gains and losses.

Resources

CCH Standard Federal Tax Reporter
IRS Publication 535 ─ Business Expenses
IRS Publication 541 ─ Partnerships
IRS Publication 583 ─ Starting a Business and Keeping Records

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Chapter 2

Capital Accounts, Basis, and Liabilities

INTRODUCTION

To begin a partnership audit, it is essential to understand some underlying concepts regarding partnership tax law. This chapter will describe:

- Capital accounts
- Partner's basis in his or her partnership interest
- Partnership's basis in its assets
- Contributions to the Partnership
- Partnership liabilities
- Accounting for Book/Tax differences
- IRC section 754 election

All of these basic concepts are a starting point for a partnership audit. This chapter will describe these concepts in general.

ISSUE: CAPITAL ACCOUNTS

Book Capital Accounts

Each partner has separate capital accounts that represent the equity that the partner has in the partnership. It relates back to a basic concept:

Assets – Liabilities = Equity.

The partners' share of equity is the amount that would be received if the partnership was liquidated and all of the assets were sold at their book value, all liabilities paid, and the net proceeds distributed. As the partnership carries on the trade or business, these capital accounts will change depending on the agreement between the partners as to how they will share in the profits and losses. The capital accounts should reflect the economic arrangement between the partners.

Many partnerships allocate their income, losses, and deductions on a straightforward pro rata basis, but some partnerships make special allocations. In cases where special allocations are made, it may be important for the partnership to gain access to the safe harbor provided in Treas. Reg. section 1.704-1(b)(2). One of the safe harbor provisions is that the partnership must maintain its capital accounts in accordance with the capital account maintenance rules found in Treas. Reg. section 1.704-1(b)(2)(iv). A partnership does not have to maintain book capital accounts in this manner. However, if special allocations are made, there is a higher risk that upon audit these allocations will not be respected. The

partnership agreement is critical to determine how the accounts are being maintained. See Chapter 6 for a detailed explanation of IRC section 704(b).

When safe harbor rules are followed the book capital accounts will be maintained using FMV (fair market value) of assets contributed net of liabilities. It is important to understand the relationship between the financial accounting of the books and records, book capital accounts, and the Form 1065 balance sheet. The partnership books and records may be kept using various methods, such as GAAP; however, they should be stated at FMV. The book capital accounts and the Form 1065 balance sheet should state the assets at FMV (net of liabilities) as of the date of contribution by the partner. The FMV of partnership assets may, over the passage of time, reflect a different amount than the partnership books and records at the date of contribution due to the appreciation or depreciation in assets. Few partnerships will obtain appraisals on a constant basis to keep the books and records at FMV. When this occurs, the Form 1065 balance sheet, the books and records, and the book capital accounts will now reflect partnership assets at what is called "book value." This is the historical cost which reflects the FMV at the date of contribution and the cost to the partnership of property purchased during the course of their trade or business. FMV becomes a different value. At this point in time, the book capital accounts, the partnership books and records, and the Form 1065 balance sheet will all reflect the "book value." The Form 1065 M-2 and Line J on the Schedule K-1 should reflect book capital accounts at FMV or in subsequent years "book value."

Tax Capital Accounts

What examiners may see in the field is that many times the books will be maintained on the tax capital account basis which will reflect the A/B (adjusted basis) of the assets contributed instead of FMV. Because the tax capital account reflects the A/B, there is a close relationship to a partner's outside basis for tax purposes which is discussed below. It will be necessary for the examiner to find out which accounting method is being used on the balance sheet and Schedule K-1. For the remainder of the discussion, the balance sheet and Schedules K-1 will be considered kept according to book capital accounts that reflect FMV at the date of contribution. Keep in mind that the tax capital accounts play a very important role in accounting for taxable gains. For example, the tax capital accounts are used to resolve the book/tax disparities discussed later in the chapter. The computations below reflect the difference between the book capital account and the tax capital account basis.

Book Capital Account

FMV of asset or cash contributed
<u>-Liability on asset assumed by the Partnership</u>
= Initial Book Capital Account Balance

Then Partnership Operations are taken into account during the year.

Beginning Capital Account Balance
+ Additional Cash and Property (at FMV) Contributed by Partner
+Allocations of Partnership Income or Gain
+Allocations of Partnership tax exempt income
-Cash distributed to the partner
-FMV of property distributed to partner net of liabilities secured by the property
-Allocations of nondeductible partnership expenses
-Allocations of partnership losses and deductions
= Book Capital Account Balance at the End of the Year

This should be reflected on the tax return balance sheet and Line J on the Schedule K-1. This can be a negative figure because the liabilities are not included here.

Tax Capital Account Basis – Tax

A/B of asset or cash contributed
-Liabilities on asset assumed by the Partner
+Gain Recognized by the Partner (if any) on Contributed Property
= Beginning Tax Capital Account

Then Partnership Operations are taken into account during the year.

Beginning Tax Capital Account Balance
+ Additional Cash and Property (at A/B) Contributed by Partner
+Allocations of Partnership Income or Gain
+Allocations of Partnership tax exempt income
-Cash distributed to the partner
-A/B of property distributed to partner net of liabilities secured by the property
-Allocations of nondeductible partnership expenses
-Allocations of partnership losses and deductions
= Tax Capital Account Balance at the End of the Year

The tax capital account balance at the end of the year can also result in a negative figure because liabilities are not included here, either.

How Do Book Capital Accounts Compare To Tax Capital Accounts?

1. Book capital accounts reflect the FMV of the property at the date of contribution and tax capital accounts reflect the adjusted basis of the property at the date of contribution.

2. Book capital accounts reflect the FMV of the property at the date of distributions and tax capital accounts reflect the adjusted basis of the property at the date of distribution.

3. Book capital accounts and tax capital accounts do not include liabilities of the partnership. They are reflected net of liabilities.

4. Book capital accounts and tax capital accounts may both reflect a negative balance. Note: It is important to keep in mind that outside basis, which will be discussed later in this chapter, can not have a negative balance. Outside basis includes liabilities. Also, see Chapter 5 - Loss Limitations.

ISSUE: PARTNER'S BASIS IN PARTNERSHIP INTEREST

Outside basis is found in IRC section 722 and is the individual partner's adjusted basis in his or her partnership interest. In general, a partner's outside basis is his or her separate **tax** capital account, which reflects adjusted basis, **plus his or her share of the partnership's debt**. Since both of these elements are quite involved, they will be discussed separately. The discussion of determining a partner's debt share is discussed later in this chapter.

Initially, outside basis is determined by including the amount of the adjusted basis in the property contributed plus any cash contributed by the partner. **If there are liabilities, outside basis includes the partner's share of all liabilities assumed.** In subsequent years, the outside basis is increased and decreased by partnership operations.

Outside basis is maintained by each individual partner outside of the partnership books. Outside basis is the computation that most examiners are concerned with because it is the basis that the taxpayer uses to limit losses, determine the taxability of partnership distributions, and compute gain/loss on the disposition of their partnership interest. Outside basis is calculated at the end of the partnership tax year.

The following is the computation of a partner's outside basis based on IRC section 722 and IRC section 705(a).

Outside Basis – A/B of a Partner's Interest

A/B in asset or cash contributed by the partner
- Liabilities of the partner assumed by the Partnership
+ Liabilities of the Partnership assumed by the partner
= Basis
+ Any Gain recognized by the Partner on the Contribution of Assets to the Partnership, See contributions, below.
= Beginning Tax Basis

Then partnership operations during the year.

+ Taxable Income
+ Tax exempt Income
+ Excess percentage of depletion
- Distributions from the Partnership of Cash or property
- Partnership expenditures that are neither deductible or capitalized by the partnership
-Oil and Gas Depletion, computed at the partner's level
-Losses
= Ending Tax Basis at year-end

This cannot be a negative balance. If it is, then losses must be carried forward to a subsequent year. See Chapter 5 for a discussion on loss limitations.

Note: Outside basis is increased by syndication costs paid at the partner level. IRC section 709(a)

The purpose of **outside tax basis** is to keep track of the partner's adjusted basis in his or her partnership interest. It is the partner's after tax investment. It is also used to determine gain or loss on the sale or other disposition of a partnership interest.

In general, to the extent that the partner withdraws his or her after tax investment in the partnership, there is no gain or loss, it merely reduces the outside basis by the amount of the withdrawal. However, some exceptions to this general rule include:

- If a partner receives a distribution of cash in excess of his or her outside basis, then the partner must report a gain for the excess. IRC section 731(a)(1). **Reduction of liabilities is considered a deemed cash distribution.** IRC section 752(b).

- If the partner receives a distribution of property in which the adjusted basis to the partnership (inside basis in the property) is more than the partner's outside basis in his or her partnership interest, then the property takes a substituted basis equal to the outside basis amount. The gain is deferred until the partner later disposes of the property outside of the partnership. IRC section 732(a)(2). In addition, the partner's outside basis is reduced to zero.

- If a partnership interest is disposed of and the partner receives more or less than his or her after tax investment in the partnership, he or she will report a gain or loss, respectively. IRC section 731(a)(1) and (2) and IRC section 741.

If the partnership attempts to allocate more losses to a partner than the partner's outside basis, these losses will be suspended until a subsequent year when the partner's basis increases due to contributions, income, gains, etc. This follows the rule that outside basis may never be reduced below zero. IRC section 704(d), IRC section 705(a)(2) and IRC section 733. (See Chapter 5 regarding loss limitations.)

As discussed earlier, book capital accounts **can be negative** and there still may be sufficient **outside basis** to take distributions, losses, etc. This is because outside basis includes the partner's share of partnership liabilities, while book capital accounts are reflected net of liabilities. This is an important distinction to keep in mind.

Quick Test for Computing Outside Basis

The Schedule K-1 does not compute the outside basis. However, a quick test for outside basis can be done by adding the ending capital account and the liabilities reflected on the Schedule K-1. This should result in a positive figure. The results may be distorted when the tax return reflects the book capital accounts at FMV because of the difference in the FMV and adjusted basis. If the tax return is prepared using the tax capital account basis, which is reflected at adjusted basis, then it is easier to make a better "best guess" estimate because outside basis is also based on adjusted basis. If the results are a negative figure then there is a potential outside basis problem.

ISSUE: PARTNERSHIP'S BASIS IN ITS ASSETS

Partnership's inside basis is found in IRC section 723 and is the partnership's tax basis in its assets. For tax purposes a partnership takes a carryover basis in contributed property equal to the contributing partners' adjusted bases in the property at the time of the contribution. Qualifying contributions are discussed later in the chapter. Inside basis is the aggregate adjusted bases of all property contributed by all partners.

There is a close relationship between inside and outside basis. They both reflect the adjusted basis of assets versus the FMV. However, outside basis deals with *each* partner's interest in partnership assets they contributed and inside basis deals with *all* partners' interests in partnership assets aggregated together. It is logical then that the sum of the partnership's inside basis in all of its assets should equal the aggregate of all partners' outside bases at formation.

Example 2-1

Facts: PRS partnership is formed. P contributes land with a basis of $100. R contributes a building with a basis of $200. S contributes $200 cash. P's outside basis is $100. R's outside basis is $200. S's outside basis is $200. PRS has an inside basis in the partnership assets of $500 ($100 in the land, $200 in the building, and $200 in cash). The total of all partners' outside bases is $500, also.

After formation, subsequent transactions may change this equality. These may include:

- Acquisition of a partnership interest at the FMV
- Death of a partner causing a basis adjustment to FMV
- Property (including cash) is distributed and the outside tax basis does not equal the partnership's basis in the property.

These situations all cause differences between inside and outside basis. An election under IRC section 754 for an optional basis adjustment will alleviate these discrepancies. This election will be discussed later.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Does the Form 1065 balance sheet on Schedule L reconcile to the partnership books and records? Does it reflect FMV or adjusted basis?

- Is the taxpayer maintaining book capital accounts according to the safe harbor rules under the substantial economic effect test in the 704 regulations? (See Chapter 6.)

- Does it appear from a quick review of the Schedules K-1 that the partners have bases in their partnership interests?

- Does it appear from the Schedule M-2 and Schedule K that there have been distributions of cash in excess of a partner's basis? If so, then gain must be recognized for the excess.

- Does it appear from the Schedule M-2 and Schedule K that there was a property distribution? If there was, then was there sufficient outside basis to reduce it by the full amount of the adjusted basis of the partnership asset? If not and a substituted basis was used, then was the property later disposed of and the correct amount of gain reported on the partner's return? If there was a potential loss from the disposition, then was it disposed of to a related party? If it was, then the loss rules under IRC section 267 apply and it must be deferred until the related party disposes of the property to an unrelated party.

Issue Identification

Ask the taxpayer if the Balance sheet is reflected at FMV or A/B. The preparers sometimes refer to the balance sheet using A/B as the "Balance Sheet on the Tax Basis." Many times this will be the situation because it easier to keep their records in this manner. This will be useful in applying the "best guess" test on the Schedule K-1 for basis. If the A/B is used then it is easier for the taxpayer and the examiners to estimate outside basis. If FMV is used then the "quick test" for basis on the Schedule K-1 is not as accurate because the FMV will be either higher or lower than cost and this will distort what the outside basis may be at first glance.

If the partnership has audited financial statements, then it is more likely that the tax return balance sheet will be reflected at FMV due to GAAP considerations. Audited financial statements are required in many instances by a provision in the partnership agreement, or when there are SBA loans, HUD loans, or other regulatory requirements.

Request a basis calculation, if it appears that there is insufficient basis for losses, distributions, etc.

Request a copy of the partnership agreement. It includes essential information for the operations of the partnership from the beginning formation to a potential sale/liquidation of an interest. It is your road map for the partnership books and tax return. If the partnership is maintaining capital accounts according to the safe harbor rules under IRC section 704(b), it will be reflected in this document. Request any amendments to the partnership agreement, also. The partners' percentage of profit sharing and loss sharing ratios will be reflected here, as well as the ownership in capital.

Match the beginning and ending capital accounts on Line J of the Schedule K-1 with the partnership balance sheet. All Schedules K-1 should be added together to arrive at the total partnership capital accounts on the balance sheet. If they do not match then request the taxpayer to reconcile them to the Schedules K-1.

Reconcile the balance sheet on Schedule L to the Partnership accounting records.

Match the beginning of the tax year figures to the prior year return's end of the year figures. If it does not match request an explanation.

Review the Schedule M-1 to ensure that it reconciles the partnership income per the accounting records with the income or loss shown on line 1 on the tax return. Request explanations regarding any unusual items. Normally the difference between book depreciation and tax depreciation will be entered here. Also, as discussed below any IRC section 704(c) depreciation allocations should be reflected here. If not, why not?

Review the Schedule M-2 to ensure it reflects the changes in the partnership capital accounts. The Schedule M-2 would reflect the amount of cash or the net FMV of property contributed during the year. It is also increased for the allocation of partnership income, including tax-exempt income or gain. It is decreased for any cash distributed to a partner. Remember that cash distributed in excess of outside basis is a taxable gain. IRC section 731(a). It is also decreased for the net FMV of property distributed. It is also decreased by the allocations to the partner of partnership expenses that cannot be deducted or capitalized and any partnership losses and deductions.

Reconcile the partner's share of items on Schedule K with the partner's Schedule K-1. This is also required for administrative purposes such as PCS controls and linkage.

Documents to Request

1. Partnership Agreement and all amendments
2. Partnership Books and Records (that is, working trial balance, depreciation schedules, income statements, balance sheets, general ledger, etc.)
3. Prior and Subsequent year partnership tax returns
4. Current year financial statements
5. Partnership Book Capital Account Calculations
6. Partner Basis Calculations (if the quick test reveals lack of basis)
7. Copies of all Loan Documents including, but not limited to, Promissory Notes, Deeds of Trust, Mortgages, Loan Payment Histories, Loan Guarantees, and/or Loan Indemnification Agreements.
8. Calculations of adjusted basis in property contributed
9. Proof of ownership by the partnership in property contributed

Interview Questions

1. Is the Balance sheet on the Form 1065 reflected at FMV or at A/B?

2. Is the partnership maintaining book capital accounts in accordance with IRC section 704(b) regulations?

3. Does the partnership maintain book capital account workpapers?

4. Does the Schedule M-2 reflects the book capital accounts?

5. Have there been any distributions in the current year?

6. Were the assets reflected on the balance sheet on the Form 1065 contributed by the partners or purchased by the partnership?

7. Were there any subsequent events that occurred that would cause the inside and outside basis to not equal? If so, was there an IRC section 754 election made?

8. Were any liabilities assumed by the partners?

Supporting Law

IRC, Subchapter K:	Section 722
	Section 723
	Section 705
	Section 731
	Section 741
	Section 734
	Section 743
	Section 754

Section 704(b) and (d)
Section 733
Section 709
IRC section 1014

Supporting regulations and specific regulations cited above.

Revenue Ruling 66-94, 1966-1 C.B. 166 – In determining the basis in a partnership interest under IRC section 705(a) distributions will be taken in account before losses of the partnership.

Resources

RIA U.S. Tax Reporter – Income Taxes

Practitioners Publishing Company, Guide to Partnerships

Cuff, New Section 743/755 Regulations for Adjusting 'Inside Basis, Journal of Taxation, (May, 2000)

ISSUE: CONTRIBUTIONS TO THE PARTNERSHIP

IRC section 721 states that the contribution of property to the partnership in exchange for a partnership interest is generally a nontaxable transaction to the contributing partner and the partnership. This applies to both contributions at the time of formation of the partnership and upon subsequent contributions. The partnership's basis in the contributed property (inside basis) is equal to the contributing partner's adjusted basis. IRC section 723. The contributing partner's adjusted basis in its partnership interest is increased by the adjusted basis in the contributed property. IRC section 722. The holding period of the partnership includes the contributing partner's holding period. IRC section 1223.

To receive non-recognition treatment there must be an exchange of property for a partnership interest. It includes a very broad range of assets, including intangibles, however, it is important to note that services are not considered qualifying property. See below for a short discussion on the contribution of services.

Non-recognition treatment applies only to *contributions* of property. Transactions that are in substance a sale or exchange of property do not qualify. See Chapter 4 for a discussion of disguised sales.

Contributions of IRC section 704(c) Property

If property is contributed that has a FMV different than its adjusted basis, then it is considered to have a **pre-contribution built-in gain or loss** and is referred to a**s 704(c) property.** At the time of contribution there will usually be no gain or loss recognized by the contributing partner or the partnership, but this pre-contribution built-in gain or loss in the property will be allocated to the contributing partner at a later date. This gain or loss is recognized when the property is disposed of, or if it is depreciable property, through yearly depreciation allocations. As a result of this delayed recognition, the book capital accounts will reflect FMV and the tax capital accounts will reflect A/B. This creates a book/tax disparity. This disparity must be accounted for. See a short discussion later relating to book/tax differences and the methods to account for these differences.

The examiner must be alert to contributions of IRC section 704(c) property and any subsequent events that may trigger a taxable event such as a disposition. It is important to keep in mind when dealing with IRC section 704(c) property there is potential for disguised sales and "mixing bowl" transactions that may trigger immediate recognition of IRC section 704(c) gain under IRC section 704(c)(1)(B) and IRC section 737. See Chapter 4 for this discussion.

Contributions of Encumbered Property

When a partner contributes property subject to a liability to a partnership, two transactions are deemed to occur at the same time. Rev. Rul. 87-120, 1987-2 C.B. 161

1. Each partner is considered to make a cash contribution equal to the *partner's* share of the liabilities assumed by the partnership.

2. Each contributing partner is considered to receive a cash distribution equal to the entire liability assumed by the partnership.

Non-recognition treatment under IRC section 721 may not apply if property is contributed that is encumbered with debt. If the contributing partner of the encumbered property is relieved of more liabilities than there is basis in his or her partnership interest, then the contributing partner will recognize a gain. This is considered a deemed cash distribution under IRC section 752(b) and is considered cash distributed in excess of the partner's basis in the partnership under IRC section 731(a).

In general, depreciation recapture is not recognized on contributions of depreciable property. However, the agent may want to consider the depreciation recapture rules as they relate to the contribution of depreciable encumbered property when a gain is recognized by a contributing partner. Treas. Reg. section 1.1245-4(c)(4), Examples 2 and 3.

Note: If the liability is non-recourse it is highly unlikely that there will be gain recognized because the operation of the non-recourse debt allocation rules. To determine if the liability has been correctly allocated for this purpose, see the discussion below on liabilities. Also, see Chapter 6.

Contributions of Unrealized Receivables and Inventory

Non-recognition treatment is allowed in most cases for the contribution of unrealized receivables from a cash basis partner to a cash basis partnership. The assignment of income principles apply to these type of transactions. The income collected from the receivables is always recognized as ordinary and allocated to the contributing partner under IRC section 704(c) to the extent that the FMV exceeds the basis at the time of contribution.

Non-recognition treatment is allowed for the contribution of inventory. If property that is considered inventory in the contributor's hands immediately before the contribution is disposed of within 5 years of the contribution date, any gain or loss by the partnership is characterized as ordinary income and is allocated to the contributing partner. IRC section 724(b) and IRC section 704(c). Even outside the 5 years, the built-in gain is allocated back to the contributing partner.

Contribution of Services

In general, the partner who contributes services for a capital interest recognizes ordinary income equal to the FMV of the partnership interest received. See IRC section 83, Treas. Reg. 1.721-1(b), ***Lehman v. Commissioner***, 19 T.C. 659 (1953), and Revenue Procedure 93-27, 1993-2 CB 343 for guidance. The contribution of services for a profits interest may result in different consequences. There are various nuances to the contribution of services for a capital or profits interest. See Chapter 11 for a discussion of this topic.

Contribution of a Partner's Promissory Note

The contribution of a partner's own promissory note may cause concern. It does not increase the partner's tax basis and the partnership also acquires no tax basis in the note at the time of contribution. However, as payments are made by the partner on the note it will constitute contributions for the amount actually paid. Rev. Rul. 80-235, 1980-2 C.B. 229

Contributions to an Investment Partnership

Generally, contributions made to an investment partnership do not qualify for non-recognition treatment. Under IRC section 721(b) gain (not loss) must be recognized on these contributions. A partnership is considered an investment partnership when more than 80 percent of the value of the assets are stocks and securities held for investment. The theory behind this is that the partner has achieved diversification and has essentially sold his investments for other investments. These are called swap funds. The character of the gain is

determined by the nature of the property in the contributing partner's hands immediately before the contribution. Treas. Reg. section 1.351-1(c)(1).

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Was there a subsequent event that would trigger a taxable gain or loss to the contributing partner on the pre-contribution gain or loss in IRC section 704(c) property? See Chapter 4.

- When the partner contributes encumbered property is the partner relieved of more liabilities than the adjusted basis in his or her partnership interest? This triggers a deemed cash distribution to the partner under IRC section 752(b) and a taxable gain under IRC section 731(a).

- Were services contributed to the partnership for a profits interest or a capital interest? A determination between these types of exchanges of interest must be made to determine if there was a taxable transaction. (IRC section 3). See Chapter 2.

- Were contributions made to a partnership that holds mostly stocks and securities? This may trigger gain on contribution. IRC section 721(b).

- Was a promissory note contributed to the partnership? The contributing partner receives basis as payments are made.

Issue Identification

Determine if there was IRC section 704(c) property contributed to the partnership. The book capital accounts and the tax capital accounts should reflect a different value for the contributed property. The examiner may look to the outside basis computation, if it is more readily available, for the adjusted basis in the asset. The examiner should verify the adjusted basis and the FMV of contributed property.

Review subsequent transactions to determine if the pre-contribution gain or loss should be recognized. It may be missing from a subsequent balance sheet or the Schedule M-2 may notate a distribution of property to a partner. This could be a distribution of the IRC section 704(c) property to another partner or the distribution of other property to the contributing partner of the original IRC section 704(c) property. There may be a disposition, a disguised sale, or a "mixing bowl" type of transaction that will all trigger gain recognition. Also, if the property was depreciable property, the separately stated depreciation deduction will not be present in subsequent Schedules K-1.

Review other types of contributions into the partnership. Be aware that if Unrealized Receivables and Accounts Payable are contributed by a cash basis

taxpayer to the accrual basis partnership, that when the partnership collects the receivables and pays the payables, the ordinary income and deduction are allocated to the contributing partner. Accounts payable, under these circumstances, are not considered liabilities for purposes of IRC section 752. Accounts payable contributed by an accrual basis taxpayer is considered a liability for purposes of IRC section 752.

Request all of the information regarding the contribution of services to the partnership at formation for both a profits interest and a capital interest so a determination can be made if this is a taxable transaction.

Review the balance sheet for the type of assets held by the partnership. If the partnership holds assets that are mostly stocks and securities, then gain may be recognized on the contributions. Losses are not recognized.

Request the valuation method and appraisal for any property contributed to the partnership. The valuation method used should be documented. If a third party appraisal was not done, consider if you need to request the services of an IRS engineer to determine the FMV of the property at the time of contribution.

Request a copy of any promissory note contributed by a partner.

Documents to Request

1. Partnership agreement.
2. Prior and subsequent year partnership tax returns.
3. Was any property contributed subject to a liability? Was it depreciable property? What method of depreciation? How much depreciation was previously claimed?
4. Copies of all Loan Documents including, but not limited to, Promissory Notes, Deeds of Trust, Mortgages, Loan Payment Histories, Loan Guarantees, and/or Loan Indemnification Agreements.
5. Appraisals and valuations for contributed property.
6. Partnership correspondence and management agreements discussing contribution of services.
7. Outside basis computations.
8. Invoices and billings as they relate to unrealized receivables and payables.

Interview Questions

1. What type of property was contributed to the partnership?

2. How was the value the property determined at the time of the contribution? Was an appraisal performed?

3. Was there a significant difference in adjusted basis and FMV at the time of the contribution of the property to the partnership?

4. Was any of the contributed property subsequently distributed to another partner?

5. Were services contributed for a profits interest or a capital interest?

6. Did any partner contribute his or her own promissory note?

7. Were any unrealized receivables or payables contributed to the partnership?

Supporting Law

IRC, Subchapter K: Section 721
Section 722
Section 723
Section 724
Section 731
Section 704
Section 737
Section 752
IRC section 83
IRC section 1223
IRC section 1245

Supporting regulations and specific regulations cited above.

Revenue Ruling 87-120, 1987-2 C.B. 161 – Increases and decreases in partnership liabilities occurring upon distribution of encumbered property are treated as occurring simultaneously for purposes of determining gain or loss to partners.

Revenue Ruling 80-235, 1980-2 C.B. 229 – A contribution of a partner's written obligation, his or her personal note, to the partnership does not increase the basis of the partner's interest under IRC section 722 because the partner has a zero basis in the written obligation.

Revenue Procedure 93-27, 1993-2 C.B. 343 – This procedure provides guidance on the treatment of the receipt of a partnership profits interest for services provided to or for the benefit of the partnership.

Lehman v Commissioner, 19 T.C. 659 (1953) – Under the partnership agreement, the Lehmans became entitled at the end of the partnership year to credits totaling $10,000 on the partnership books, this sum to be debited from the other partners' capital accounts. The tax court stated that this was ordinary income. It was the same as though the other partners had paid them $10,000 in cash to be placed in their capital accounts.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Practitioners Publishing Co., Guide to Partnerships

ISSUE: PARTNERSHIP LIABILITIES

A partner's outside basis is made up of his tax capital account which reflects the adjusted basis of assets contributed and his or her share of the partnership's liabilities. Determining a partner's debt share is critical to determining his or her basis in his partnership interest.

First the examiner needs to determine if a liability actually exists. Revenue Ruling 88-77 discusses the definition of a partnership liability. In general, if the liability provides basis in a partnership asset or gives rise to a current partnership deduction, then it is a partnership liability. Once it is determined that a liability exists then IRC section 752 applies.

IRC section 752 is structured to keep a close correlation between inside and outside basis. If deductions are funded by partnership debt within the partnership, then IRC section 752 increases the outside basis to allow the partners the benefit of the deduction. In this way it could be said that "liabilities follow the losses and the deductions."

Losses and deductions are essentially funded either by the partner's own capital contributions or by borrowed funds. When a partnership borrows money with which to purchase assets or pay for operating expenses IRC section 752 considers it to be the same as if the partners had contributed the money to the partnership. This principle is based on a landmark Supreme Court case***, Crane v. Commissioner***, 331 U.S. 1, 67 S.Ct. 1047 (1947). The taxpayer borrowed funds to acquire an asset. The court stated that the taxpayer was entitled to basis in the asset immediately. The taxpayer did not have to repay the debt currently to obtain outside basis as long as it could be reasonably expected that the taxpayer would repay the loan in the future.

There are two ways to repay a loan:

1. The partner can contribute cash to repay the loan, or
2. The partnership is profitable and repays the loan

These two ways reflect a relationship between recourse and non-recourse debt. The question is, if a loan defaults, who bears the ultimate economic risk of loss and has the responsibility to repay the loan? It is determined by the nature of the debt.

Determining Debt Share

In determining the partner's share of the partnership debt, it is critical to identify the nature of the debt.

A **recourse debt** is one in which the creditor can pursue the partners. If the partnership is not profitable and does not make payments on the loan, then the partners are required to take **cash** out of their pocket to repay the loan. They will either have to make a contribution to the partnership or repay the loan directly. The **partners** who are responsible to repay the debt bear the economic risk of loss. These are usually the general partners who are jointly and severally liable for partnership debt.

If a limited or general partner guarantees the recourse debt, there would be no special allocation of debt to that partner's basis because the guaranteeing partner could still pursue the general partners for reimbursement. This holds true unless the guarantor waives all rights of subrogation, and then the liability may be allocated to that partner. There should be written documentation to substantiate this.

In general, we ultimately look to the partners' loss sharing ratios to allocate the recourse liabilities. The partner's share of recourse liabilities are reflected on Line F under "other" on the Schedule K-1.

A **non-recourse debt** is one in which the property may be the only security for the loan, therefore the creditor cannot pursue the partners, individually. In this case, the creditor can only hope for the partnership to be **profitable** so the debt will be repaid. The **creditor** bears the economic risk of loss. None of the partners bear the economic risk of loss. If the partnership is not profitable and cannot repay the loan, then the partners are not obligated to take cash out of their pocket to repay the loan.

If a limited or general partner guarantees the non-recourse debt or makes a direct loan to the partnership, they would ultimately be economically at-risk because there would be no chance of reimbursement by the other partners. This is barring any side agreement with another partner for reimbursement. The liability would be allocated in its entirety, for outside basis purposes, to the partner guaranteeing the loan.

In general, we ultimately look to the partners' profits sharing ratios to share in the non-recourse liabilities. The partner's share of non-recourse liabilities are reflected on Line F under "Non-recourse" on the Schedule K-1. The partner's share of non-recourse loan guarantees and any non-recourse direct loans by the partner to the partnership should be reflected on Line F under "other" on the Schedule K-1. Also, included on Line F on the Schedule K-1 is Qualified Non-recourse Financing. This is discussed in Chapter 5 on At-Risk Limitations.

- The partnership agreement will contain the profit and loss sharing ratios. Remember that the ratios must have substantial economic effect under IRC section 704(b). IRC section 704(b) may override the partnership agreement. (See Chapter 6 for details on IRC section 704(b)).

Whether the debt is recourse or non-recourse determines which of the two different avenues that the examiner must take through the regulations. They are:

Loss Sharing Percents Recourse	Profits Sharing Percents Non-recourse
Repayment by Contribution Treas. Reg. section 1.752-2(b)(1)	Repayment by Profits Treas. Reg. section 1.752-3(a)(1)

Recourse Liabilities – Repayment by Contributions. The regulations lead the examiner through a "hypothetical constructive liquidation" to determine a partner's risk of loss. Treas. Reg. section 1.752-2(b)(1).

Constructive Liquidation – All of the following are deemed to happen.

1. All partnership liabilities become due and payable in full.
2. All of the partnership assets are worth $0.
3. All of the partnership assets are sold for $0 with a loss recognized to the extent of the entire basis in each asset.
4. All items of income, gain, loss, or deduction are allocated under the partnership agreement to partners according to their loss sharing arrangement which must have substantial economic effect under the IRC section 704 regulations. The allocation of loss reduces the capital accounts and results in negative capital accounts which represents the partner's risk of loss. This is the amount of recourse debt that is added to their outside basis.
5. Evaluate the partners' contribution obligations based on their resulting capital account balances.

Example 2-2

General Partnership Situation - A and B are general partners and share in profits and losses equally. They each initially contribute $20 of cash. The partnership purchases a tract of land for $200. It uses the $40 for a down payment and finances $160 with recourse debt.

Constructive Hypothetical Liquidation

Amount Realized	$ 0
Basis in Land	200
Loss Recognized	(200)

Book Capital Accounts	A (50%)	B (50%)
Cash Contributions	20	20
Distributive Share of the Losses Allocated under IRC section 704(b)	(100)	(100)
Partner's Risk of Loss Determines Share of Debt	(80)	(80)

Outside Basis – Tax Basis		
Cash Contributions	20	20
Partner's Risk of Loss/Share of Debt IRC section 752(a) & IRC section 722	80	80
Outside Basis	100	100

In this example both A and B would contribute to the partnership or repay the liability directly for $80 each.

Example 2-3

Limited Partner Situation - A is a General Partner and B is a limited partner. A contributes initially $10 and B contributes $90. The partnership purchases a tract of land for $1000. It makes a down payment of $100 and finances $900 with recourse debt. B is not obligated to contribute any further to the partnership, general partner A, or the creditors.

Constructive Hypothetical Liquidation	
Amount Realized	$ 0
Basis in Land	1000
Loss Recognized	(1000)

Book Capital Accounts	A (10%)	B (90%)
Cash Contributions	10	90
*B is not permitted to have a ($900) loss because there is not economic risk of loss so the allocation is under IRC section 704(b)	910	90
Partner's Risk of Loss Determines Share of Debt	(900)	0

Outside Basis – Tax Basis		
Cash Contributions	10	90
Partner's Risk of Loss/Share of Debt IRC section 752(a) & IRC section 722	900	0
Outside Basis	910	90

* Under Treas. Reg. section 1.704-1(b)(2) there must be substantial economic effect which ties to IRC section 752. IRC section 704 overrides the partnership agreement. So B only has basis in the initial contribution of $90.

- If B had been obligated to restore $100 beyond his contribution per the partnership agreement, then $100 more of the losses would be allocated to B's outside basis. B's outside basis would increase to $190 and A's outside basis would decrease to $810.

- If B had assumed the liability and will pay the entire amount when it comes due, then Treas. Reg. section 1.752-1(d)(3) states that 3 conditions must be met. The assumption is tied to Treas. Reg. section 1.704-1(b)(2)(iv)(c). The 3 conditions are the following:

  1. B must be personally liable.
  2. Creditor must know of B's assumption and can enforce it.
  3. There is no reimbursement to anyone – Important!

There should be a separate side agreement for the assumption.

Non-recourse Liabilities – Repayment by Profits. When a creditor is limited to repayment only through the property securing the debt and cannot pursue A or B, then no partner bears the economic risk of loss. The creditor is the only one that bears the economic risk of loss and could lose money upon default of the loan. Since the creditor cannot look to the partners, then profits of the partnership must repay the loan.

Under former Treas. Reg. section 1.752-1(e), a partner's share of non-recourse debt was based purely on the partners' profit sharing ratios. The rationale was that only partnership profits would be used to repay the debt. The regulations were revised to describe three different categories or layers of debt allocation that must be used in allocating the partnership's non-recourse debt to the partners.

Final Treas. Reg. section 1.752-3 (Effective October 31, 2000), Revenue Ruling 92-97, and Revenue Ruling 95-41 discuss 3 layers that must be applied in order to allocate the non-recourse debt to basis properly.

These 3 layers are as follows:

1. Partner's share of IRC section 704(b) partnership minimum gain
2. Partner's share of IRC section 704 (c) minimum gain
3. Partner's share of excess non-recourse debt – The partner is allocated any excess non-recourse liabilities not allocated to layers 1 and 2 under one of several methods that the partnership may choose. They may choose to allocate with the partner's share of partnership profits per the partnership agreement or allocate based on certain reasonably expected deductions. Additionally, per the final regulations, the partnership may first allocate an excess non-recourse liability to a partner up to the amount of the built-in gain that is allocable to the partner on IRC section 704(c) property or property for which reverse section 704(c) applies, where such property is subject to the non-recourse liability to the extent that such built-in gain exceeds the gain

described in layer 2 with respect to such property. This additional method does not apply for purposes of Treas. Reg. section 1.707-5(a)(2)(ii) and does not apply to any liability incurred or assumed by a partnership prior to October, 31, 2000. To the extent that a partnership uses this additional method and the entire amount of the excess non-recourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess non-recourse liability under one of the other methods described in the regulations for the third layer. Final Treas. Reg. section 1.752-3(c), Example 3, describes in detail how this method applies.

What is IRC section 704(b) partnership minimum gain? It is the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the non-recourse liability and for no other consideration. Refer to Treas. Reg. section 1.752-3, Example 1.

What is IRC section 704(c) minimum gain? It is the amount of gain that would be recognized if the partnership disposed of IRC section 704(c) appreciated property in full satisfaction of the debt and for no other consideration (Non-recourse liability on the contributed property over the adjusted basis in that property). Refer to Treas. Reg. section 1.752-3, Example 1.

What are excess non-recourse liabilities? These are all non-recourse liabilities not accounted for in layers 1 and 2. The allocations are determined in accordance with the partners' share of partnership profits that may be allocated differently per the partnership agreement for layer 3. This happens because there may be special allocations for non-recourse deductions (that is, depreciation) that are allocated to one particular partner. The corresponding non-recourse liability must be allocated to that particular partner to allow outside basis to take the deduction. If these types of allocations are made they must have substantial economic effect under IRC section 704(b). If they do not, then the non-recourse liabilities should be allocated by the profits interest in effect for other items per the partnership agreement or allocated up to the amount of the built-in gain that is allocable to the partner of IRC section 704(c) property or reverse IRC section 704(c) allocations that exceed layer 2 gain. Refer to Treas. Reg. section 1.752-3(c), Examples 2 and 3.

The allocation of excess non-recourse liabilities can change every year so examiners need to request the partnership agreement and any amendments. If the partnership agreement is silent in this area then the profits interest ratios should be used per the Schedules K-1.

- If any partner guarantees the loan then this will override the non-recourse liability scenario and it will be considered a recourse liability in which the partner would bear the economic risk of loss and the new recourse liability would be allocated to that partner only. Treas. Reg. section 1.752-2(f) Example 5.

- If any partner or related person directly loans the partnership cash, and the loan is non-recourse, then that partner bears the economic risk of loss and the

non-recourse liability will be allocated entirely to that partner's basis. Treas. Reg. section 1.752-2(c). There can be no right of reimbursement from another partner. Treas. Reg. section 1.752-2(b)(5). See Treas. Reg. section 1-752-4(b) for definition of a related party.

LLC members are not liable for the debts of the partnership per state law. Loans are considered all to be non-recourse unless the member guarantees the loan or makes a direct loan to the partnership. If it is qualified non-recourse financing which, in general, is a non-recourse loan secured by real property, then it is possible for the members to be considered at-risk and losses will be allowed. See Chapter 5 for at-risk limitations under IRC section 465.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Are liabilities properly allocated to the partner's basis according to the economic risk of loss concept?

- Are recourse liabilities for general partners being properly allocated to the proper partner? Are direct loans being allocated properly? No special allocation should be made to the partner loaning the money. The general partner making a direct recourse loan can still seek reimbursement from the other general partners.

- Are guarantees of recourse loans by either a limited or a general partner being allocated under normal recourse rules? No special allocation should be made for these guarantees unless the guarantor waives all rights of subrogation and then all of the liability may be allocated to that partner. There should be a side agreement substantiating this.

- Was there a relief of liabilities over the adjusted basis in the partnership interest? If so then this is a deemed cash distribution (IRC section 752(b)) and gain will be recognized (IRC section 731(a)).

- If there is any disagreement as to whether a loan is recourse or non-recourse, obtain written advice from local Counsel.

Issue Identification

Review the balance sheet and partner's Schedule K-1 for non-recourse liabilities. They should be reflected on the designated line on the balance sheet and Schedule K-1. However, accounts payable may be non-recourse liabilities, as well as other long-term or short-term notes. Find out what type of liabilities are reflected on the balance sheet for purposes of the proper basis allocation and for at-risk purposes. Accounts payable increase outside basis under the non-recourse allocation rules and will probably fluctuate from year to year. See Chapter 5 for the at-risk limitations.

Request a copy of the partnership agreement to determine profit and loss sharing ratios. The agreement will also determine if a limited partner must contribute additional cash over and above its initial contribution.

Analyze all recourse and non-recourse loan documents to determine who is at-risk of loss if the partnership defaults on these loans.

Analyze all recourse loans for guarantees by either a general or limited partner. The guarantees are disregarded unless the partner waives the right of subrogation. In most cases the general partners are still ultimately responsible to reimburse any partner that made payments on a recourse loan.

Analyze all non-recourse loans for guarantees. All of the liability will be allocated to the partner guaranteeing the loan unless there is a side agreement entitling the partner to reimbursement.

Analyze all direct loan documents by a partner to the partnership. Determine if these represent arms length liabilities to the partnership or capital contributions because loans that should be classified as capital contributions may be classified as loans in order to give other partners outside basis to deduct losses that they may not be entitled to. Also, if the loan is recourse in a general partnership then the partner will be entitled to reimbursement from the other general partners. General partners are jointly and severally liable for partnership loans so normal allocation of recourse loans will be used versus all of the loan being allocated to that partner. If the loan is a non-recourse liability then all of the liability will be all allocated to the lending partner. This is true because the partner will not be entitled to any reimbursement unless there is a side agreement allowing reimbursement from another party.

Request any side agreements with creditors to determine if any of the partners are entitled to reimbursement, if they assume a loan for the partnership.

Request any indemnification agreements or other side agreements between partners that entitle the partners to reimbursement by another partner. The liability will be allocated to the partner that will ultimately be at-risk of loss to pay the debt.

Request a computation of how the recourse and non-recourse liabilities were allocated to the various partners.

Documents to Request

1. Partnership agreement and all amendments.
2. Prior and subsequent year partnership returns.
3. Copies of all Loan Documents including, but not limited to, Promissory Notes, Deeds of Trust, Mortgages, Loan Payment Histories, Loan Guarantees, and/or Loan Indemnification Agreements.
4. Side agreements between a partner and a creditor for assumptions.
5. Indemnification or side agreements between partners for reimbursement.
6. Security agreements.
7. Outside Basis calculations.
8. Computations of recourse and non-recourse allocations.

Interview Questions

1. What does each liability on the balance sheet represent? Are they recourse or non-recourse debt?

2. Are there debt instruments? If so, request copies.

3. Are there any guaranteed loans? Which ones?

4. Are there any indemnification agreements or side agreements between the partners and another partner or person related to the partner?

5. Are there any assumptions of debt by any of the partners? If so, is there a side agreement with the creditor?

6. Are there any direct loans from a partner to the partnership? Are they recourse or non-recourse?

Supporting Law

IRC, Subchapter K: Section 752
IRC section 704
Supporting regulation and specific regulations cited above.

Crane vs. Commissioner, 331 U.S. 1, 67 S. Ct. 10147 (1947) – The court discussed how a taxpayer who acquired depreciable property subject to an unassumed mortgage holds it for a period and finally sells it still subject to the mortgage computes her taxable gain.

Revenue Ruling 88-77, 1988-2 C.B. 128– This ruling provides guidance on what is considered a partnership liability.

Revenue Ruling 92-97, 1992-2 C.B. 124 – This ruling provides guidance on the allocation of partnership cancellation of indebtedness income.

Revenue Ruling 95-41, 1995-1 C.B. 132 – This ruling provides guidance on the effect of IRC section 704(c) on the allocation of non-recourse liabilities under Treas. Reg. section 1.752-3(a).

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Practitoners Publishing Co., Guide to Partnerships

Len Schmolka NYU IRS Teleconference for Partnerships
Partnership Book - Cunningham

ISSUE: BOOK/TAX DIFFERENCES – CONTRIBUTED PROPERTY

Underlying the substantial economic effect rules is the premise that if the partnership allocates its book items in a particular manner that the corresponding tax items must follow the same method. This is where the phrase "tax must follow book" comes from. The most common instance occurs when there is a contribution of IRC section 04(c) property. Another instance relates to revaluations in which the adjusted bases of assets are booked up to FMV. It must be made for a substantial non-tax reason. Revaluations will not be discussed in any length, here. It is important for examiners to be aware that this may occur and they should refer to Treas. Reg. section 1.704-1(b)(2)(iv)(f) for a discussion of the requirements.

In both of these situations, the book accounts which are recorded at FMV are already reflecting the inherent gain or loss in the assets, however, for tax capital account purposes the inherent gain or loss has been deferred. At a later time when the assets are disposed of, there will be a tax gain or loss to report. Due to this difference, tax will not follow book. These differences must be accounted.

The regulations identify three methods that can be used to account for the book/tax disparity relating to the pre-contribution built-in gain or loss and revaluations. These methods allow tax to follow book. They are the following:

- Traditional method
- Traditional method with curative allocation
- Remedial allocation method

The primary method is referred to as the traditional method. The two other methods are used to supplement the traditional method to cure problems created with the ceiling rule. The rules do not require the taxpayer to choose a method to

cure the ceiling rule problem, they only suggest several methods. The taxpayer may select any other reasonable method. Treas. Reg. section 1.704-3

If the **IRC section 704(c) property** is **nondepreciable** property then the book/tax disparity is resolved at the time of disposition by sale or a distribution to another partner. Since the book capital accounts were adjusted at the time of contribution for the FMV, this in effect, gave the contributing partner the book gain, but not the tax gain yet. When the property is disposed of there is a tax gain. The pre-contribution built-in gain or loss will be allocated to the contributing partner. Any additional gain or loss attributable to the partnership since the contribution date is allocated among all partners in accordance Treas. Reg. section 1.704-3. Even though this was a delayed transaction for tax purposes, this allows tax to follow book at the time of disposition.

Example 2-4: Traditional Method

Facts: PR partnership is formed. P contributes land with a FMV of $100 and a basis of $40, and R contributes $100 cash. P and R are 50/50 partners. In year 1, PR partnership sells the land for $100. The entire $60 gain is allocated to P because there was a pre-contribution built-in gain at the time of P's initial contribution. The capital accounts at formation would have looked like this:

Capital Accounts	P		R	
	Book	Tax	Book	Tax
Capital Contribution	100	40	100	100

The $60 disparity between P's book and tax capital accounts represents the pre-contribution built-in gain at the time of contribution. The disparity requires that a special allocation be made under IRC section 704(c) to prevent the shifting of tax benefits and burdens.

Same facts, but the land was sold for $150 instead, then the first $60 of pre-contribution gain would still be allocated to P. The remaining post-contribution gain of $50 would be allocated 50/50, $25 to P and $25 to R. The books would look like this following the transaction.

Capital Accounts	P		R	
	Book	Tax	Book	Tax
Capital Contribution	100	40	100	100
Gain (built-in)	0	60	0	0
Gain (post-contribution)	25	25	25	25
Adjusted Capital Accounts	125	125	125	125

In this example, the ceiling rule limitation did not apply because the property had appreciated in value causing a post-contribution gain on the sale of the property.

Using these same facts, let's see what happens when the property depreciates in value. The land was sold for $80 which generates a book loss of $20 and a $40 tax gain. The books would look like this following this transaction.

	Capital Accounts			
	P		R	
	Book	Tax	Book	Tax
Capital Contribution	100	40	100	100
Gain/Loss on sale	(10)	40	(10)	0
Adjusted Capital Accounts	90	80	90	100

Under the ceiling rule, PR partnership is prevented from allocating a tax loss to R to eliminate the disparity between the book and tax capital accounts because PRS did not incur a tax loss.

Under the traditional method, the noncontributing partner's book/tax disparity remains unless it can be *cured* or *remedied* with the curative allocation method or the remedial allocation method.

There is an appropriate ordering rule for allocations. Book items are considered first, and then traditional allocations (Treas. Reg. section 1.704-3(b)) are next. Depending on the selection by the taxpayer, the curative allocation method (Treas. Reg. section 1.704-3(c)) or the remedial allocation method (Treas. Reg. section 1.704-3(d)) follow.

If the **IRC section 704(c) property** is **depreciable** property then the book/tax disparity is resolved on a yearly basis with depreciation deductions until the property is disposed of. The noncontributing partner will be allowed a larger depreciation deduction. This in effect allocates more income to the contributing partner. In this way the contributing partner begins to recognize a small portion of gain at a time. The application of the methods listed above apply to depreciable IRC section 704(c) property, as well. This depreciation allocation should be reflected as a separately stated item on the Schedule K-1. It should also be reflected on the Schedule M-1.

De Minimis Rule – If the difference between the FMV and tax basis of the contributed property is not more than 15 percent of the adjusted basis of the property, and the total disparity is not more than $20,000, IRC section 704(c) may be disregarded. Treas. Reg. section 1.704-3(e).

These rules can become complicated. It is important to keep in mind that the taxpayer may select any of these methods in the regulations or another reasonable method. However, the method chosen must have substantial economic effect. Examiners will need to request the taxpayer's records that reflect their computations.

Examiners should consider the **anti-abuse rules** under Treas. Reg. section 1.704-3(a)(10) when reviewing the method used by the taxpayer to account for book/tax

differences. The regulations state that an allocation method is considered unreasonable if the contribution and the subsequent allocations 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 partner's tax liability. If there is a significant difference in the partners' tax brackets, then this may be a red flag to take a closer look. All facts and circumstances must be considered. The regulations give two examples of unreasonable allocation methods.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Is the taxpayer using a reasonable method to account for book/tax differences?
- Are the depreciation allocations being reported on the proper Schedules K-1?
- Are the pre-contribution built-in gains or losses being reported to the contributing partner upon disposition of the IRC section 704(c) property?
- Were there any revaluations? Did the business purpose meet the requirements in the regulations?
- Is there any intent to substantially reduce tax liability for any partner by shifting allocations?

Issue Identification

Request the computations for the accounting of book/tax differences relating to IRC section 704(c) property and revaluations.

Request the computations for any depreciation allocations associated with depreciable IRC section 704(c) property.

Review the Schedules K-1 to determine if the depreciation allocations have been reported to the appropriate partners.

Review the Schedule M-1 to determine if the depreciation book/tax differences are reflected in the reconciliation of book to tax.

Determine if the taxpayer is using a reasonable method, if the three methods in the regulations are not being used.

Determine if there is an intent to substantially reduce a partner's tax liability by shifting allocations.

Documents to Request

1. Partnership agreement
2. Prior and subsequent year partnership tax returns
3. Partners' tax returns
4. Calculations of the method used to account for book/tax differences
5. Depreciation schedules

Interview Questions

1. What method does the taxpayer use to account for book/tax differences?

2. Have there been any re-valuations in prior or subsequent years?

3. How was the depreciation allocation handled on the Schedules K-1?

4. Was there a Schedule M-1 adjustment for the depreciation allocation?

Supporting Law

IRC, Subchapter K: Section 704
Supporting regulation and specific regulations cited above.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Practitioners Publishing Co., Guide to Partnerships

The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, Laura E. Cunningham and Noel B. Cunningham

TTV Update – Decoding Subchapter K – IRS Corporate Education

ISSUE: OPTIONAL BASIS ADJUSTMENTS – IRC section 754 ELECTION

The purpose of an IRC section 754 election is to provide a way to alleviate differences between inside and outside basis caused by:

1. Transfer of a partnership interest (IRC section 743(b)), or
2. Distribution to a partner (IRC section 734(b))

IRC section 755 describes how to allocate the adjustments.

IRC section 743(b)

The following types of transactions will trigger inside basis and outside basis discrepancies for IRC section 743(b):

- Sale or exchange of a partnership interest
- Transfer of a partnership interest by inheritance

If there is a transfer of a partnership interest and the FMV of the interest is different than the adjusted basis in the partnership interest then a discrepancy will occur. The discrepancy will occur between the partnership's inside basis in its assets which reflects adjusted basis, and the outside basis of the new transferee partner's share of the partnership assets (partnership interest) which reflects FMV. This causes an inequity because the new transferee partner has paid for the unrealized gain or loss in the partnership assets. If no IRC section 754 election is in effect, then the discrepancy will create a permanent difference between inside and outside basis until the partnership is liquidated. If there is an IRC section 54 election in effect then it is resolved by taking into account the gain or loss and depreciation associated with the transaction, and attributing it all to the new transferee partner. The other partners outside basis remain unchanged. All partners must agree to the IRC section 754 election.

Example 2-5

A and B share in profits, losses and capital 50 percent each. The partnership has the following:

Assets			Capital Accounts		
	A/B	FMV		A/B	FMV
Land	60	100	A	30	50
			B	30	50

The adjusted basis in the partnership assets (inside basis) is $60. A and B's outside basis is $30 each. B sells his partnership interest to C for $50. C's outside basis is now $50. C's share of partner's adjusted basis in the partnership assets (inside basis) is $30. There is now a discrepancy. Now, if the partnership sold the land for $100 FMV there is a gain of $40. A $20 gain would be allocated to both A and C. C has already in effect paid for his or her share of the unrealized gain at the time of the acquisition.

- If there was no IRC section 754 election in effect, this will create a permanent difference until the partnership is liquidated.

- If there was an IRC section 754 election in effect then the $20 gain step-up is all attributable to C by virtue of increasing the basis in the land to $80. The gain of $20 (100-80=20) on the sale of the land is all allocated to A. It is important to keep in mind that a basis step-down may result if the FMV is less than the adjusted basis of the

partnership interest when an IRC section 754 election is in effect.

IRC section 734(b)

The following types of transactions will trigger inside and outside basis discrepancies under IRC section 734(b):

- Distributions to a partner where gain or loss is recognized (that is, cash in excess of basis)
- Distributions of property to a partner resulting in a lower or higher basis in the hands of the partner than the partnership's adjusted basis in the same property

If there is a property distribution to a partner and there is a gain or loss recognized or the partner takes a higher or lower basis in the asset than what the partnership's basis reflected, then an inequity results to the remaining partners.

Example 2-6

ABCD Partnership has one asset, land with $60 adjusted basis and $100 FMV. The partnership agrees to liquidate C's 1/4 partnership interest for $25. C's outside basis is $15. C is receiving excess cash over the adjusted basis in the partnership interest of $10. C recognizes a capital gain of $10.

- If there was no IRC section 754 election in effect and the property was sold after liquidating C's interest for the $100 FMV, the remaining partners will recognize a $40 gain instead of a $30 gain.

- If there was an IRC section 754 election in effect, then the $10 gain that was already reported by C would be taken into account by stepping up the inside basis and allocating it to the remaining partners so that they would report the correct amount of gain.

Note: If there is a distribution of property other than cash to a partner within 2 years of acquiring a partnership interest, the partner may elect, <u>without an IRC section 754 election in place</u>, to adjust the basis in the property in the distributee partner's hands. There is no effect on the property still remaining in the partnership. IRC section 732(d)

If depreciable property is involved, it makes it more complicated because of the depreciation deduction. If there is IRC section 704(c) property contributed, either nondepreciable or depreciable, there are further complications because of the various allocation methods, such as traditional, curative allocations, and remedial allocations, mentioned above, that must be considered under the IRC section 704(c) principles. It is necessary to consider all of these factors when reviewing the IRC section 754 election computations.

IRC section 755

IRC section 755 is the allocation method used to reduce the differences between the adjusted basis and the FMV of partnership property. Final Regulations, effective December 14, 1999, allow offsetting positive and negative adjustments between classes and within classes. (IRC section 755(b) and Treas. Reg. section 1.755-1(a)). The final regulations adopted the proposed regulations, effective January 1998. The rules prior to 1998 did not allow offsetting positive and negative adjustments. Different rules apply to the allocation under IRC section 743(b) and IRC section 734(b). There are numerous examples in the regulations that describe the allocation calculations.

Recordkeeping for this election is very cumbersome and is done by the partnership. Under normal circumstances, once a partnership elects under the provisions of IRC section 754, this election is irrevocable without the Commissioner's consent. **Final regulations effective on December 14, 1999,** for IRC section 743(b), IRC section 734(b), and IRC section 755, allows partnerships a one-time revocation of the IRC section 754 election. This may be done if the partnership had an election in place in a tax year that included December 15, 1999. If they choose to revoke this pre-existing election, they must follow the rules in Treas. Reg. section 1.754-1(c)(2). These rules stipulate that the statement of revocation must be attached to a timely filed partnership return (including extensions). It must include the name and address of the partnership along with a signature by an authorized partner. The front of the partnership return must state at the top of the first page that the "return is filed pursuant to Treas. Reg. section 1.754-1(c)(2)." Many partnerships will make this one-time revocation because of; 1) their massive recordkeeping requirements, and 2) an IRC section 754 election can be a two-edged sword because it can not only cause increases in basis, but decreases to assets which can result in larger gains. It is a crucial election to the partnership so it is important to request all recordkeeping.

Examination Techniques

- Analyze the balance sheet to see if there is an IRC section 754 election in effect, because there should be a change in the value of the assets.

- Analyze the Schedule K and Schedule K-1 to determine if depreciation deductions are being allocated to a new partner.

- Analyze the Schedule K-1 to determine if there has been a change in the ownership interests.

- Analyze the Schedule M-2 to determine if there have been any distributions of property that may trigger the IRC section 754 election, if it is in effect.

- Analyze the Line 22 and 23 on Schedule K to determine if the distribution was cash or other property.

- Review prior and subsequent years to determine if there were any changes in ownership.

- Request a copy of the IRC section 754 election.

- Request a copy of any IRC section 754 revocation of the election.

- Request the partnership agreement. It may state how the IRC section 754 election will be made and the details surrounding the partnership making the election.

- Analyze the Schedule M-1 for increases or decreases in book depreciation versus tax depreciation. This may alert the examiner that there is either an IRC section 754 election in effect and there was a transaction involving depreciable property which now has an increased or decreased basis, or that there was an IRC section 704(c) property contribution.

- Request the IRC section 743(b), IRC section 734(b), and the IRC section 755 calculation for the IRC section 754 elections. The partnership must keep the books and records to account for these.

Issue Identification

If an IRC section 754 election is in effect, then is the partnership treating all transactions that fall within this category according to the rules of IRC section 754? Sometimes the election is not to the benefit of the partnership at a later date, but unless there was a valid revocation, the appropriate basis adjustments must be made.

Analyze and review all subsequent transactions that may have occurred regarding IRC section 743(b) and IRC section 734(b) to make sure that the proper partners are allocated the correct amounts. These type of transactions may occur every year.

Analyze prior year partner contributions to determine if IRC section 704(c) property was contributed and there is an IRC section 754 election in effect. There will be special allocations to partners taking into account the methodologies used to account for the book/tax differences such as remedial allocations, etc., as mentioned above.

Documents to Request

1. Partnership agreement
2. Prior and subsequent year partnership tax returns
3. Partnership books and records
4. Partnership elections for IRC section 754
5. Partnership revocations of IRC section 754
6. Partnership calculations of the IRC section 743(b) and IRC section 755 adjustments

7. Partnership calculations of the IRC section 734(b) and IRC section 755 adjustments
8. Documents regarding any sales and exchanges of partnership interests
9. Schedule of distributions to partners of property
10. Outside basis calculations to partners that are affected by the IRC section 754 election in current year
11. Depreciation schedules
12. Valuations or appraisals for any property distributed

Interview Questions

1. Does the partnership have an IRC section 754 election in effect?

2. Has the IRC section 754 election been revoked?

3. Were there any property distributions in the current year?

4. Were there any partnership transfers of interests?

5. Did any of the partners receive their interest from an inheritance?

6. Does the partnership have calculations to support the IRC section 743(b), IRC section 734(b), and IRC section 755 adjustments?

Supporting Law

IRC, Subchapter K: Section 754
Section 743
Section 734
Section 755

Supporting regulations and specific regulations

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Practitioners Publishing Co., Guide to Partnerships

Chapter 3
Contributions of Property with Built-in Gain or Loss
IRC section 704(c)

INTRODUCTION

When a partner contributes appreciated or depreciated property to a partnership, the property has an inherent built-in gain or built-in loss that accrued in the hands of the partner. Thus, at the time of contribution, the property has a tax basis that differs from its fair market value. As was discussed in Chapter 2, the property's fair market value at the time of contribution is what is called the "book basis". This type of property is referred to as "704(c) property."

The goal of IRC section 704(c) is to prevent the shifting of tax consequences (gain, loss, and deductions) with respect to appreciated or depreciated property contributed by a partner to a partnership. It upholds the assignment of income principle by requiring the contributing partner to be taxed on the portion of the gain or loss that accrued prior to the property's contribution. This chapter will cover:

- IRC section 704(c) in the context of non-depreciable property
- IRC section 704(c) in the context or depreciable property
- IRC section 704(c) in the context of amortizable property
- Impact of IRC section 704(c) on the sharing of non-recourse liabilities
- The Anti-Abuse Rule
- "Reverse" IRC section 704(c) which addresses re-valuations

Overview

Prior to 1984, there was no special rule that a contributing partner had to be taxed on the gain or loss inherent in property at the time of contribution. In 1984, Congress took action against partners' ability to shift pre-contribution gain or loss among themselves and made IRC section 704(c) mandatory. As a result, gain or loss inherent in contributed property must be allocated back to the contributing partner. In the case of non-depreciable property, this can happen all at once when the property is sold. On the other hand, gain or loss inherent in depreciable property will be recognized over time as depreciation deductions are allocated to other partners and *away* from the contributing partner, thereby increasing the contributing partner's income.

Final regulations for 704(c) were issued on December 21, 1993. These regulations include an anti-abuse rule in Treas. Reg. section 1.704-3(a)(10). A firm grounding in the basic operation of IRC section 704(c) is critical to understanding the proper allocation of gain, loss, and cost recovery pertaining to IRC section 704(c) property. Additionally, IRC section 704(c) principles have an impact on a contributing partner's share of partnership non-recourse debt.

ISSUE: IRC SECTION 704(c) AND NON-DEPRECIABLE PROPERTY

Example 3-1

Adams and Miller form an equal partnership in which Adams contributes raw land with a tax basis of $10,000 and a fair market value of $50,000. Miller contributes $50,000 of cash. The land is IRC section 704(c) property because there is a $40,000 appreciation that occurred prior to its contribution to the partnership. Its book basis is $50,000 and its tax basis is $10,000.

If the partnership were to sell the land for $50,000, the entire gain would be allocated to Adams.

If the land appreciated in the hands of the partnership and it were sold for $100,000, $50,000 would be split equally between Adams and Miller and the built-in gain of $40,000 would be allocated to Adams.

Consistent with the assignment of income principles, Miller is only allocated a portion of the gain that accrued during the time that he owned the land via the partnership. All of the built-in gain of ($40,000) that accrued prior to contribution is allocated back to the contributing partner.

Allocation Methods – Non-depreciable Property

Although straightforward in its aim of upholding the assignment of income principle and taxing the contributing partner on any built-in gain or loss, IRC section 704(c) becomes more intricate when there has been a tax gain but a book loss.

Example 3-2

Taking the facts from the above example, if the land decreased in value to $30,000 and was sold, there would be a tax gain of $20,000 ($30,000 less tax basis of $10,000). Following IRC section 704(c) principles, this gain would be allocated to Adams. Miller, on the other hand, has suffered an economic loss but has no accompanying tax loss. Remember that Miller bought an undivided interest in a partnership that owned land worth $50,000. The land had a book basis of $50,000 and was sold for $30,000, resulting in a $20,000 book loss. The problem here is that there is no tax loss to match Miller's book (or economic) loss.

How this problem is addressed depends on which allocation method the partnership elects.

The regulations discuss three allocation methods:

- Traditional Method
- Traditional Method with Curative Allocations
- Remedial Method

The traditional method with curative allocations and the remedial method, are designed to remedy the noncontributing partner's lack of a tax loss allocation in the presence of an economic loss. Under the traditional method, the noncontributing partner's lack of a tax loss to match his economic loss is not corrected until the partnership liquidates or that partner sell its partnership interest.

Traditional Method

This method focuses solely on taxing the contributing partner on his built-in gain. The noncontributing partner is forced to wait until the partnership liquidates in order to get a tax loss to match his economic loss. In the above example, the partners' tax capital and book capital accounts are as follows:

	Contributing Partner Adams		Noncontributing Partner Miller	
	Tax	**Book**	**Tax**	**Book**
Initial Balance	10,000	50000	50,000	50,000
Land Sale	20,000	-10,000	0	-10,000
	30,000	40,000	50,000	40,000

If the partnership were to distributes its cash of $80,000 in complete liquidation, (Miller's initial cash contribution of $50,000 plus $30,000 from the sale of the land), the results would be as follows:

	Contributing Partner Adams	Noncontributing Partner Miller
Outside Basis	30,000	50,000
Cash Distributed	(40,000)	(40,000)
IRC section 731 Gain	10,000	
IRC section 731 Loss		10,000

Instead of having a current tax loss, Miller has a loss which will only be recognized upon disposing of his partnership interest. Under the traditional method, this result is caused by the **ceiling rule,** which states that tax items allocated to partners with respect to IRC section 704(c) property cannot exceed the total tax items associated with that property. In other words, Miller is not allocated a tax loss in conjunction with his book loss because the partnership doesn't have one to give him.

Traditional Method with Curative Allocations

A partner may not be willing to defer until tomorrow a tax loss associated with today's economic loss. Because the ceiling rule will not allow the partner to take a non-existent allocation, the regulations permit a partnership to elect curative allocations. In making a curative allocation, a partnership looks at the tax items it

has generated for the year and searches for one that is of the same character as the item that was limited by the ceiling rule. If the partnership has such a tax item, that item is "borrowed" and then allocated in a manner for tax different than the manner in which it was allocated for book. The result is that the noncontributing and the contributing partners are allocated offsetting items – the noncontributing partner receives a loss or a gain reduced from what he would normally have received, and the contributing partner receives the mirror opposite.

Remedial Allocation Method

Unlike the curative allocation method, the remedial method does not force the partnership to look for a tax item that truly exists. Instead, the partnership simply invents what it needs – it manufactures whatever tax allocations the noncontributing partner needs to accompany his book allocations. At the same time, it invents an offsetting item in the same amount as the fictional tax items and allocates it to the contributing partner. Thus, any remedial allocations of loss to one partner will result in an offsetting allocation of gain to the other partner. It is important to realize that in spite of their purely fictitious origins, remedial allocations are real for tax purposes. They affect both the partners' tax liabilities and their outside bases. Since these allocations are created solely for tax purposes, they do not affect the partners' book capital accounts.

Example 3-3

In the Example 3-2, Miller has a $10,000 book loss with no accompanying tax loss. Under the remedial allocation method, the partnership creates a tax loss of $10,000 for Miller and a tax gain of $10,000 for Adams:

	Contributing Partner Adams		Noncontributing Partner Miller	
	Tax	**Book**	**Tax**	**Book**
Initial Balance	10,000	50,000	50,000	50,000
Land Sale	20,000	(10,000)	0	(10,000)
Remedial Allocation	10,000		(10,000)	
	40,000	40,000	40,000	40,000

Note that the book capital accounts are not affected by the remedial allocation. Also, as a result of the remedial allocation, the tax capital and the book capital accounts are equal.

ISSUE: IRC SECTION 704(c) AND DEPRECIABLE PROPERTY

Example 3-4

Al contributes equipment with a FMV of $100 and an adjusted basis of $40. The equipment is 10-year depreciable property with a 5-year remaining life. The partnership will depreciate it under the straight-line method. Betty contributes $100 cash. Under the partnership agreement, Al and Betty are equal partners. The partnership's book basis in the equipment equals the FMV of the property at contribution, $100. The partnership's tax basis in the equipment equals the contributing partner's tax basis at the time of contribution, $40. In Year 1, the equipment generates book depreciation of $20 and tax depreciation of $8.

Note: Without IRC section 704(c), Al and Betty, as 50/50 partners, would share the tax depreciation equally.

The partners' capital accounts would be adjusted as follows in the first year:

	Al		Betty	
	Tax	**Book**	**Tax**	**Book**
Capital Account	40	100	100	100
Depreciation Deduction	(4)	(10)	(4)	(10)
Adjusted Capital Accounts	36	90	96	90

Although Betty is the owner of half of the property's fair market value (that is, half of $100), the depreciation deductions Betty receives over the remaining 5-year life, under a pro rata allocation of depreciation, deductions ($4 per year for 5 years, or $20) do not equal half of the property's fair market value. In terms of cost recovery, Betty would have been better off purchasing a one half interest in the property directly from Al. The IRC section 704(c) allocation methods address this inequity between book and tax allocations.

Traditional Method

Under the traditional method, the noncontributing partner is allocated tax depreciation, to the extent of real tax depreciation available, up to his or her amount of book depreciation. To the extent permitted by the ceiling rule, the noncontributing partner is treated as if he or she purchased an undivided interest in the contributed property.

Example 3-5

Assume the same facts as in Example 3-4 except that the partnership uses the traditional allocation method. The partnership's capital accounts are as follows:

	Al		Betty	
	Tax	**Book**	**Tax**	**Book**
Capital Account	40	100	100	100
Traditional Allocation	0	(10)	(8)	(10)
Adjusted Capital Accounts	40	90	92	90

The ceiling rule limits the allocation to $8 because that is the total partnership tax depreciation for the year.

Traditional Method with Curative Allocations

As was described earlier, if the traditional method with curative allocations is used then the partnership looks for another tax item of the same amount and character as the item limited by the ceiling rule. This item must exist in the partnership's tax house for that year; otherwise no curative allocation can be made. If the partnership has such an item, it will further reduce Betty's book/tax disparity.

Example 3-6

Assume the same facts as in Example 3-5, except that the partnership has $4 of ordinary income to be allocated.

The partnership's capital accounts are as follows:

	Al		Betty	
	Tax	**Book**	**Tax**	**Book**
Capital Account	40	100	100	100
Traditional Allocation	0	(10)	(8)	(10)
Balance	40	90	92	90
Curative Allocation	4	2	0	2
Adjusted Capital Accounts	44	92	92	92

The partnership uses the curative allocation method and allocates the entire $4 of income to Al. Alternatively, if the partnership had $4 of deductions available, a disproportionate allocation of $4 of deductions could be made to Betty.

Remedial Allocation Method

When used in conjunction with depreciable property, the remedial method uses a special rule for calculating the amount of book depreciation. It introduces a split depreciation scheme. Recall that when property is transferred to a partnership, the partnership normally steps into the shoes of the contributing partner and continues to depreciate the property using the same method and the property's remaining life. Under the remedial allocation method, the portion of the book basis equal to the adjusted tax basis is recovered in this manner. The remainder of the book basis (book basis less tax basis) is recovered as if it were a newly purchased asset placed in service at the time of contribution.

Example 3-7

Al contributes equipment with a FMV of $100 and an adjusted basis of $20. The equipment is 10-year IRC section 1245 property with a 5-year remaining life. Betty contributes $100 cash. Under the partnership agreement, Al and Betty are equal partners. The partnership's book basis in the equipment equals the FMV of the property at the time of contribution, $100. The partnership's tax basis in the equipment equals Al's tax basis at the time of contribution, $20. The partnership uses the remedial allocation method. Assume that the partnership has no income.

The tax basis portion of the equipment ($20) is depreciated over its remaining 5-year life. The excess ($80) is depreciated as if it were a newly purchased asset. In this example, it is depreciated over a 10-year life.

The annual depreciation deduction for the first 5 years is calculated as follows:

Equipment		
	Tax	**Book**
Book = Tax ($20), 5 years	4	4
Book > Tax ($80), 10 years	0	8
Total Depreciation	4	12

The remedial allocation method yields the following result in the first year:

	Al		Betty	
	Tax	**Book**	**Tax**	**Book**
Capital Account	20	100	100	100
Traditional Allocation	(0)	(6)	(4)	(6)
Balance	20	94	96	94
Remedial Allocation	2	0	(2)	0
Adjusted Capital Accounts	22	94	94	94

The remedial allocation method totally eliminates Betty's book/tax disparity each year because the partnership is able to manufacture exactly what is needed. The curative allocation method in the prior example only eliminates Betty's book/tax disparity if the partnership actually has other income or deductions in the appropriate amount and character.

Method Summary

The most obvious difference between the traditional allocation method and the other two (curative allocations and remedial allocation methods) is that under the traditional method, the contributing partner can shift taxable income to other partners if the ceiling rule applies. A high bracket taxpayer will thus favor the traditional method because there are no curative or remedial allocations to prevent income shifting.

For depreciation or amortization purposes, the noncontributing partner may favor the traditional method with curative allocations. This is because the excess book basis may be depreciated over a short remaining life. In contrast, the remedial method will bifurcate the asset and start a whole new depreciation period for the "excess book basis asset" which may be a longer time period.

It should be remembered that the partnership can use any reasonable method of making allocations. The partnership is not limited to the three methods described in the regulations. Whether or not a method will be considered to be "reasonable" will depend on whether or not the allocations cause the contributing partner to bear the tax benefits and burdens of the built-in gain or loss. Allocations that are not consistent with the assignment of income doctrine would obviously not be reasonable.

The choice of method may be made on a property-by-property basis Treas. Reg. section 1.704-3(a)(2).

ISSUE: IRC SECTION 704(c) AND IRC SECTION 197 INTANGIBLES

Allocations of amortization deductions are made in accordance with IRC section 704(c) on contributed intangible assets with built-in gain or loss. IRC section 197 was enacted in 1993 to simplify the law regarding the amortization of certain acquired intangibles. It established a mandatory 15-year recovery period for assets such as goodwill, trademarks, franchises, licenses granted by governmental agencies, and customer-based intangibles. Other assets, such as patents and copyrights, are amortizable under IRC section 197 if they are purchased as part of a trade or business.

To properly apply the IRC section 704(c) allocation methods, it must first be determined whether the intangible asset contributed by the contributing partner is amortizable under IRC section 197. The general definition of Section 197 intangibles is found in IRC section 197(d) and includes, in part, goodwill, going concern, patents, copyrights, and licenses. The definition of an amortizable 197 intangible is found in IRC section 197(c)(1). There are two requirements for a 197 intangible to be considered to be an amortizable 197 intangible: Generally, the asset must be:

1. Acquired by the taxpayer after August 113, 1993, and
2. Held in connection with the conduct of a trade or business or an activity described in IRC section 212

Note that intangibles acquired by the contributor prior to the enactment of IRC section 197 are not amortizable IRC section 197 intangibles, (with the exception of a taxpayer making an election to apply the provisions of 197 to property acquired after July 25, 1991).

There is an important exclusion from the definition of amortizable IRC section 197 assets that addresses certain self-created assets. This is found in IRC section 197(c)(2). If self-created, any of the following assets will be not be amortizable under IRC section 197: goodwill, going concern value, workforce in place, business books and records, patents, copyrights, formulas, processes, designs, patterns, knowhow, format, customer-based intangibles, supplier-based intangibles, and other similar items. (Note that governmental licenses, covenants not to compete, and franchises, trademarks, and trade names do not fall within the exclusion.)

Allocation Methods for Amortizable 197 Intangibles

In situations where the contributed asset was an amortizable IRC section 197 intangible in the hands of the contributor, the partnership may make either curative or remedial allocations of amortization. It is important to note that this also applies to a zero-basis intangible that otherwise would have been amortizable to the contributing partner (that is, if the asset had basis).

Example 3-8

XYZ Corporation owns and operates a broadcasting station which has been in business since 1985. In January 1995, the corporation purchases additional licenses from the Federal Communications Corporation for $150,000 and began using them in the active conduct of the business. These 1995 licenses are described in IRC section 197 and are amortizable over the mandatory 15-year recovery period. In January 1997, when the licenses have increased in value to $500,000, XYZ forms an equal partnership with ABC Corporation to expand XYZ's existing business operations. XYZ contributes the licenses and ABC contributes $500,000 cash.

Since the licenses are amortizable IRC section 197 intangibles in the hands of XYZ Corporation, the partnership may make either curative or remedial allocations to the noncontributing partner, ABC to amortize its share of the partnership's licenses.

Recall that the remedial method treats the excess of the book basis over the tax basis of the contributed property as if it were a newly created asset with a new holding period. Under the remedial method, the partnership would treat the contributed property as if it were two assets, one with a basis of $130,000 (the original tax basis of $150,000 less accumulated amortization of $20,000), and the other with a basis of $370,000 (the difference between the tax basis of $130,000 and the book basis of $500,000). The tax portion of $130,000 is amortizable over the remaining 13 years of its recovery period. The built-in gain portion of $370,000 is treated as a newly purchased asset by the partnership and is amortizable for book purposes over a new 15-year period. Thus in 1997, ABC receives a remedial allocation of amortization in the amount of $12,333 ($370,000/15 = 24,666/2 = 12,333).

Example 3-9

Post 1993 Goodwill

Ken starts a business in 1998. In 2000 he forms a 50/50 partnership with Jose who contributes $1,000,000 cash. The assets of Ken's business consisted of equipment with a basis and a FMV of $300,000 and self-created goodwill with a zero basis and a FMV of $700,000. The goodwill is not an amortizable IRC section 197 intangible in Ken's hands because it is a self-created asset. IRC section 197(c)(2). However, if the goodwill had basis, it is the type of asset that otherwise would be amortizable to the contributing partner (goodwill acquired after the enactment of IRC section 197). The partnership can make either curative or remedial allocations to Jose to amortize his share of the partnership's goodwill. Ken will receive no amortization deductions because he had a zero basis in the goodwill.

Allocation Method for Nonamortizable IRC section 197 Intangibles

For assets that were nonamortizable in the hands of the contributor, the partnership may make amortization allocations to the noncontributing partner

only using the remedial method. The contributing partner will be allocated remedial income and the noncontributing partners will be allocated matching remedial amortization deductions.

Example 3-10

Pre 1993 Goodwill

Ken starts a business in 1989. In 1994, he forms a 50/50 partnership with Jose, an unrelated person, who contributes $1,000,000 cash. The assets of Ken's business consisted of equipment with a basis and a FMV of $300,000 and self-created goodwill with a zero basis and a FMV of $700,000. The goodwill, in the hands of Ken, is not an amortizable IRC section 197 intangible because it was created prior to the enactment of IRC section 197. The partnership can only use the remedial method to amortize Jose's share of the partnership's goodwill. Ken will receive no amortization because the goodwill was not an amortizable IRC section 197 intangible in Ken's hands.

Anti-Churning Rules

Remedial allocations may not, however, be made if the partner contributing the nonamortizable intangible and the noncontributing partners are related and the asset is subject to the anti-churning rules of IRC section 197. The purpose of the anti-churning rules is to prevent taxpayers from transforming assets which were not of a character to be amortized prior to the enactment of IRC section 197 into amortizable assets by selling them to a related party. Thus, the anti-churning rules may limit the amortizability of intangibles acquired by a partnership or from a partnership in a transaction involving related parties. See the following example:

Example 3-11

Ken starts a business in 1985. Fortunately, the business is successful and earns profits in every year. As of 1995, his business consists of two assets, equipment with a basis and a FMV of $300,000 and self-created goodwill with a basis of zero and a FMV of $700,000. The goodwill is an IRC section 197 intangible, but it is not an amortizable IRC section 197 intangible in Ken's hands because it was created prior to the enactment of IRC section 197. In 1995, Ken forms a partnership with a corporation in which he is the sole shareholder. Ken contributes his business to the partnership and the partnership adopts the remedial method for making allocations. Because the noncontributing partner (the wholly owned corporation) is related to Ken and because the intangible was owned by the contributing partner prior to the enactment of IRC section 197, the partnership is unable to amortize the asset. Thus, the corporation is prohibited from receiving remedial allocations of amortization.

Prior to the enactment of IRC section 197, intangibles that had a determinable useful life and a tax basis were amortizable over their useful lives. If these types of assets are sold between related parties, the anti-churning rules will not apply. See the following example:

Example 3-12

A publisher owns a subscription list (customer-based intangible) that has a determinable useful life, an ascertainable value, and a zero tax basis. The list was created prior to the enactment of IRC section 197. A partnership is formed with the publisher and the publisher's subsidiary as partners. In 2000, the publisher sells the customer list to the partnership and amortizes the list. Even though this is a related party transaction, the partnership will be able to amortize the list because it was an asset of a character subject to amortization prior to the enactment of IRC section 197.

Contrast the above example with the following:

Example 3-13

A real estate management partnership has management contracts which were acquired prior to the enactment of IRC section 197. The contracts have an indefinite life. The partnership would like to be able to amortize the contracts under IRC section 197. The partnership sells the contracts to a corporation which is wholly owned by the partnership. In this case, the corporation will not be able to amortize the contracts because they were held by a related party prior to the enactment of IRC section 197 and because they were not of a character subject to amortization.

ISSUE: ANTI-ABUSE RULE

The 704(c) regulations contain an anti-abuse rule in Treas. Reg. section 1.704-3(a)(10) which states that an allocation method is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting 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.

Additionally, Treas. Reg. section 1.704-3(a)(2) states that it may be unreasonable to use one method for appreciated property and another method for depreciated property. While IRC section 704(c) applies on a property-by property basis, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate.

ISSUE: EFFECT OF IRC SECTION 704(c) ON PARTNERS' SHARE OF NON-RECOURSE LIABILITIES

As was discussed in Chapter 2, a partner's share of non-recourse liabilities is the sum of three amounts defined in Treas. Reg. section 1.752-3. 704(c) impacts the calculation of the second amount, and it can have an impact on the third amount, the excess non-recourse liabilities for partnerships using the optional method. Treas. Reg. section 1.752-3(a)(3). The IRC section 704(c) method is relevant only to the extent of "extra excess" IRC 704(c) amounts. For a review of the basics of calculating a partner's share of non-recourse liabilities, see Chapter 2.

As seen in Revenue Ruling 95-41, the IRC section 704(c) allocation method employed by the partnership can affect the amount calculated under Treas. Reg. section 1.752-3(a)(2), which is the amount of any taxable gain that would be allocated to the partner under IRC section 704(c) if the partnership disposed of the property in full satisfaction of the liability. In analyzing a hypothetical sale to determine this amount, it is necessary to make two calculations, one using the property's tax basis and one using the property's book basis. The impact of the hypothetical sale on the partnership's noncontributing partner must be taken into consideration.

Revenue Ruling 95-41 gives an example of an equal partnership formed between A and B. A contributes IRC section 704(c) property having a basis of 4,000 and a fair market value of $10,000. The property is encumbered with $6,000 of non-recourse debt. B contributes $4,000 cash. If the partnership disposed of the property for satisfaction of the debt and no other consideration, it would be as follows:

Tax		**Book**	
Amount Realized	6,000	Amount Realized	6,000
Tax Basis	4,000	Book Basis	10,000
Tax Gain	2,000	Book Loss	4,000

Traditional Method: Partner A would be allocated $2,000 of gain from the hypothetical sale of the contributed property. Therefore, A would be allocated $2,000 of non-recourse liabilities under Treas. Reg. section 1.752-3(a)(2) immediately after contributing the property. Recall that under the traditional method, there are no offsetting allocations, so A's gain (and therefore his liability share under Treas. Reg. section 1.752-3(a)(2)) is only $2,000.

Remedial Method: Partner B, the noncontributing partner has a $2,000 book loss in the hypothetical sale. Under the traditional method, B would not have a tax loss to accompany his book loss because the partnership has no tax loss to give him. The remedial method, however, can manufacture a tax loss to allocate to B and the ceiling rule applies. If this happens, a tax gain in an equal amount must be manufactured to allocate to A. Thus, under the remedial method, A has not only a $2,000 hypothetical tax gain on the sale of the property but also A has a $2,000 hypothetical offsetting allocation of gain created by using the remedial

method. Thus, under the remedial method, since A would be allocated $4,000 of gain in the hypothetical sale, A will have a $4,000 share of the non-recourse liabilities under Treas. Reg. section 1.752-3(a)(2).

Although a contributing partner may not look favorably on the prospect of being allocated notional items of income or gain under the remedial method during the partnership's operating years, the remedial method does have the advantage of potentially increasing the contributing partner's non-recourse liability share under Treas. Reg. section 1.752-3(a)(2).

Traditional Method with Curative Allocations: If the partnership were to use the traditional method with curative allocations, it would be able to make reasonable allocations to B to allow B to have a tax loss that more closely reflects his economic loss. The hypothetical sale scenario, however, cannot shed light on what items the partnership might use for curative allocations. Therefore, curative allocations are not taken into account in determining debt share under Treas. Reg. section 1.752-3(a)(2). If the partnership used the traditional method with curative allocations, A would be allocated $2,000 of non-recourse liabilities for the Treas. Reg. section 1.752-3(a)(2) sharing layer.

ISSUE: "REVERSE" 704(c) – REVALUATIONS

Consistent with the assignment of income doctrine, a new partner who pays a fair market value for a partnership interest should not be taxed on the built-in gain or loss that accrued in the partnership's assets prior to the time of his arrival. While IRC section 704(c) deals with newly contributed property, "reverse" IRC section 704(c) requires that the existing partners be taxed on the appreciation or depreciation that occurred prior to the admission of a new partner. See Treas. Reg. section 1.704(a)(6).

Assuming that the partnership is following the capital account maintenance rules, the entry of a new partner by contribution will ordinarily result in the restatement of the partnership's book capital accounts to reflect the fair market value of partnership assets. At this point, there will be a disparity between the book and tax capital accounts of the existing partners, analogous to the book/tax disparity of a partner who contributes property with a built-in gain or loss.

All of the principles of IRC section 704(c) previously discussed are applied in this situation. The difference from the prior examples is that it is the "existing partners" are in the same position as the "contributing partner" and the "new partner" is analogous to the "noncontributing partner". For example, the new partner will want to be allocated the amount of depreciation or amortization that he "paid" for; under the traditional method, the ceiling rule may prevent this.

Examination Techniques

- Make a 3-year comparison of the balance sheet to identify newly contributed property.
- Review the partnership agreement not only for instances of contributed property, but also to ascertain what IRC section 704(c) allocation method is being used.
- Review appraisals of contributed property and decide in the beginning of the audit if an engineering referral should be made.
- Review the returns of all of the partners. If the partnership is making remedial or curative allocations to the noncontributing partner, make sure that the contributing partner is picking up the offsetting allocations.
- Make sure that offsetting allocations are passed through to the contributing partner's return.

Issue Identification

- If intangibles have been contributed to the partnership, the examiner will want to review IRC section 197.

- If depreciable IRC section 704(c) property has been sold, the examiner should carefully review Treas. Reg. section 1.1245-1(e)(2)(iv) to calculate recapture. Remedial and curative allocations can complicate the calculation of recapture.

- Check to see if the allocation method applied to a specific property is consistent from year to year

Documents to Request

- Partnership Agreement
- Appraisals of contributed property
- Appraisal of value of partnership upon entry of a new partner
- Letter, memos, or minutes, or agreements pertaining to contributed property
- Schedule reflecting non-recourse liability sharing

Interview Questions

- What property was contributed upon formation of the partnership?
- What property was contributed subsequent to formation?
- Have new partners entered this partnership? If so, how was the purchase price determined?
- What IRC section 704(c) allocation method is in place?

Supporting Law

IRC section 704(c), IRC section 197, IRC section 1245, Treas. Reg. section 1.752-3 pertaining to the sharing of non-recourse liabilities and Revenue Ruling 95-41

Resources

The Logic of Subchapter K, 2d Edition (2000), Laura E. Cunningham and Noel B. Cunningham
Federal Income Taxation of Partners and Partnerships, Karen C. Burke
Revenue Ruling 95-41: A Favorable Analysis for Allocating Partnership Non-recourse Debt, The Journal of Real Estate Taxation
Allocation of Non-recourse Liabilities: IRS Takes Two Steps Forward, One Back, Journal of Taxation November 1995
Use and Abuse of Section 704(c), Laura E. Cunningham, 3 Fla. Taxation Revue 92 (1996)
Blake Rubin and Andrea Macintosh, Exploring the Outer Limits of the Section 704(c) Partnership Built-in Gain Rule, Parts I, II, and III, 89 Journal of Taxation (September, October, and November 1998)

Chapter 4

Distributions

INTRODUCTION

As a general rule when a partner transfers property to a partnership gain or loss is not recognized. Additionally, partners generally do not recognize gain or loss when they receive distributions from a partnership unless it is cash in excess of the outside basis.

Although the general rule aims to treat partnership distributions as nontaxable events, the exceptions can quickly overshadow the general rule. The possibility of moving property in and out of partnerships unimpeded by tax considerations creates potential for abuse. Transactions, which are essentially sales, can masquerade as tax-free distributions. To prevent income or basis shifting among partners, several provisions track property movements. It is not possible, for example, for partners to use their partnership as a device to "swap" appreciated or depreciated property among themselves. It is in these areas that examiners may find the most potential for adjustments.

This Chapter will describe:

- Basics ─ Current and Liquidating Distributions
- Disguised Sales
- Distributions of Built-in Gain or Loss Property to a Noncontributing Partner
- Distributions of Property to a Partner that Contributed Built-in Gain or Loss Property
- Disproportionate Distributions

ISSUE: BASICS –- CURRENT AND LIQUIDATING DISTRIBUTIONS

Distributions fall into two categories under IRC section 731(a)(1):

1. **Current** distributions (**Nonliquidating** distributions)
2. **Liquidating** distributions

In a **current** distribution, the partnership is simply distributing money or property to a continuing partner. On the other hand, a **liquidating** distribution completely terminates the partner's interest in the partnership. A single distribution or a series of distributions can liquidate the interest.

It is important to remember that the reporting of partnership income and the actual distribution of cash may not occur simultaneously. A partner must report his distributive share of partnership income in his taxable year in which (or with

which) the partnership's taxable year ends. That may or may not be the same year in which he or she receives a distribution of partnership profits.

As with sales of partnership interests, distributions can be complicated by the presence of IRC section 751 assets (unrealized receivables and inventory) which have ordinary income potential. Whether or not this complication must be considered depends on whether the partner receives a proportionate or disproportionate share of these assets. If the distribution does not upset the partners' original share of the partnership's ordinary income assets, it is a proportionate distribution and the regular distribution rules apply. If, on the other hand, a partner receives more or less than his or her share of IRC section 751 assets, the transaction will be treated as a sale or exchange. IRC section 751 must be considered for both current and liquidating distributions. The determination of a proportionate share is determined based on the fair market value of the assets instead of the bases of the assets. See the discussion later in this chapter regarding disproportionate distributions.

This section of the chapter will only consider proportionate (pro rata) distributions. These are distributions in which the partner's share of IRC section 751 and Non-IRC section 751 assets remain unchanged after the distribution. The regular distribution rules will apply in these instances.

Proportionate Current Distributions

A current distribution is one in which the partner's interest in the partnership continues. The following items must be considered:

- Partnership will not recognize a gain or loss. IRC section 731(b)
- Partner will generally not recognize gain. IRC section 731(a).
- Partner will **never** recognize a **loss.** IRC sections 731(a) and 732(a)
- Determination of basis and character of the property distributed by the partnership to the partner after the distribution. IRC section 732 and IRC section 733.
- Determination of basis and character in a subsequent disposition of the distributed property. IRC section 735.
- Determination of the basis of undistributed property left in the partnership if under IRC section 734(a) there is an IRC section 754 election in effect.

Example 4-1

Mike and Lenny are partners in an investment partnership. They each have a basis in their partnership interest of $2,000. The partnership distributes $1,500 to each partner. They would each have a tax- free distribution of $1,500 and their capital accounts would be reduced to $500.

- **Gain is only recognized to the extent that money is distributed in excess of the partner's adjusted basis** in the partnership interest. IRC section 731(a)(1). For distribution purposes, money includes cash, any decrease in a partner's share of partnership liabilities (IRC section 752(b)), and the fair market value of marketable securities IRC section 731(c)(1)(B).)

Loss is never recognized by the partner in a current distribution. IRC sections 731(a)(2) and 732(a)(1) and (2).

There is a close inter-relationship between the partner's amount of outside basis in the partnership interest and the basis that is assigned to distributed assets. Distributions of cash and property reduce outside basis. The total amount of basis that can be assigned to property distributed is limited to the partner's outside basis in the partnership interest prior to the distribution.

Basis of Distributed Property in Current Distributions

Generally, the **basis of distributed property** to the partner is the adjusted basis of the property to the partnership immediately before the distribution. Assuming that the partner has enough outside basis, property distributed will have a straight carryover basis. IRC section 732(a)(1) and (2).

The exception to this general rule occurs when the partnership's adjusted basis in the property distributed exceeds the partner's basis in his or her partnership interest. When this occurs, the basis in the distributed property will be limited to the partner's adjusted basis in his or her partnership interest reduced by any money received in the same transaction. The distributee's outside basis is allocated among the distributed items in the following order:

- Cash, including relief of liabilities, and the FMV of marketable securities
- IRC section 751 Assets
- Other Non-section 751 Property

If cash, the relief of liabilities, or the FMV of marketable securities exceeds the partner's outside basis, no basis will be available to allocate to either IRC section 751 assets or other property. Depending on the fair market value of the distributed assets, it is possible for a partner to have an ongoing interest in a partnership, but a zero outside basis. A liquidating distribution will always result in a zero outside basis, while a current distribution may or may not.

When the basis assigned to distributed assets (either IRC section 751 or Non-IRC section 751) is limited by the partner's outside basis, IRC section 732(c)(3) provides a method for decreasing the bases of distributed assets. The decrease is first allocated to properties with unrealized depreciation. Any remaining decrease is allocated among properties in proportion to their respective fair market values. This method applies to distributions occurring after August 5, 1997. Prior to this date, this decrease was allocated based on the partnership's adjusted bases in the properties.

Effect of an IRC section 754 Election – Optional Basis Adjustment

IRC section 734(a) states that the basis of undistributed property shall not be adjusted as the result of a distribution of property to a partner unless an IRC section 754 election is in effect. If an IRC section 754 election is in effect, then there shall be an increase to the adjusted basis of the undistributed properties equal to the gain recognized by the partner under IRC section 731(a) (money, relief of liabilities, and FMV of marketable securities in excess of partner's partnership basis).

Additionally, the IRC section 734(b) adjustment will increase the bases of the partnership's remaining properties by the amount by which the adjusted basis in the property distributed exceeds the adjusted basis of the partner's outside basis in his or her partnership interest as described in IRC section 732(a)(2). In other words, if the partner takes more basis out of the partnership than the amount of the partner's outside basis, IRC section 734(b) will rectify the resulting disparity between inside and outside basis. For examples of how IRC section 734(b) operates in the context of distributions, see Chapter 3.

Character and Holding Period of Distributed Property

When the distributed property is disposed of at a later date, the character of the gain or loss on disposition is governed by IRC section 735.

- The gain or loss on the disposition of unrealized receivables will be ordinary regardless of the distributee partner's holding period.

- The gain or loss on the disposition of inventory is ordinary if the inventory is disposed of within 5 years of the distribution date. If the disposition takes place 5 years after the date of the distribution, then the character of the gain or loss depends on the inventory's character in the hands of the distributee partner at the date of sale (that is, inventory, capital asset, trade or business asset). Treas. Reg. section 1.735-1(a)(2). If an inventory item appreciates in the distributee partner's hands, the post-distribution appreciation will also be subject to the 5-year ordinary income taint period.

- In general, a partner's holding period for the property distributed to him or her by a partnership includes the partnership's holding period. This does not apply to determining the 5-year rule for inventory items noted above. Treas. Reg. section 1.735-1(b) and IRC section 1223(2). The ordinary income taint will remain with the property even if the distributee partner subsequently contributes the property to another entity. Inventory items will retain their ordinary income character in the hands of either a transferee partnership or corporation for a 5-year period. Here are several examples that illustrate these concepts.

Example 4-2

B is a partner in ABC partnership. B received a current distribution of $90,000 cash and land with an adjusted basis to the partnership of $60,000. B's outside adjusted basis in his partnership interest is $100,000. This was considered a pro rata distribution.

B's Basis in Ptrship Interest	$100,000	
Cash Received	(90,000)	IRC section 732(c)(1)
Balance	10,000	No Gain $ < A/B
Land Received	(10,000)	IRC section 732(c)(2) & (a)(2)
Balance of Ptr's interest	0	IRC section 733

Note: There is no gain recognized because the money distributed was not in excess of the partner's basis in his partnership interest. IRC section 731(a)(1).

What will be the distributee partner's basis in the property received? Under IRC sections 732(a)(1) and (a)(2), it is the carryover basis in the hands of the partnership

Except: Basis cannot exceed the SMALLER of:

- Partnership adjusted basis in the property (Carryover Basis)
- Partner's adjusted basis in his partnership interest less:
  - Cash Distributed

In this case, when applying the above formula, the land now has a basis of $10,000 in the distributee partner's hands. The holding period tacks generally unless it is unrealized receivables or inventory. Treas. Reg. section 1.735-1(b) and IRC section 1223(2).

What if the property distributed to the partner involved either debt assumed by the partner or relief of debt to the partner? The following would result:

- IRC section 752(a) states that any debt assumed by a partner is considered a contribution of money to the partnership. A contribution of money adds to the partner's basis in his or her partnership interest.
- IRC section 752(b) states that any debt relieved to a partner by the partnership is considered a distribution of money. A distribution of money subtracts from the partner's basis.

What is the effect to the partnership? None. IRC section 731(b).

Example 4-3

Same facts as Example 4-2 except what if B received $101,000 cash instead? There would be a gain recognized of $1,000 under IRC section 731(a)(1) because there was a distribution of cash in excess of the

adjusted basis in the partner's interest in the partnership. The character of the gain can be found in IRC section 731(a)(2) which states that the gain is treated as a sale of a partnership interest. A sale of a partnership interest is governed by IRC section 741 which states that the character is like the sale of a capital asset.

What is the effect to the partnership? None. IRC section 731(b).

Example 4-4

On January 1, 1995, ABC partnership distributes cash of $5 to each partner and $30 of inventory to each partner. This is considered a pro rata distribution. The balance sheet appears as follows:

Balance Sheet of ABC Partnership

	Adjusted Basis	FMV
Cash	60	60
Accounts Receivable	0	39
Inventory	60	90
Land	30	90

The result is:

Outside Bases in the Partnership

	A	B	C
Balance	40	30	20
Cash Distributed	5	5	5
Balance	35	25	15
Inventory	20	20	15
Ending balance	15	5	0

Note: There would be no gain recognized by any of the partners because the cash received was not more than the outside basis of any of the partners. Partners A and B would receive the inventory with a $20 carryover basis. The carryover basis as you recall is the adjusted basis the partnership had in the asset immediately before the distribution. Partner C would be limited to the basis in his partnership interest of $15. Therefore upon later disposition, the inventory would have an adjusted basis to Partner C of $15, and to Partners A and B of $20 each.

Later: January 1, 1997 – Partner C sells the inventory for $40.

Amount Realized	$40
Adjusted Basis	15
Gain	25

IRC section 735(a)(2) – There was less than 5 years between the distribution and the subsequent sale so it would be an ordinary gain.

What if Partner C sells the inventory for $40 on January 1, 2001? This would be more than 5 years from the original distribution. In this case under IRC section 735(a)(2) the character of the gain would depend on the character of the asset in the hands of the seller/distributee partner. If the asset was now being held as a capital asset or a trade or business asset, it would be capital gain or IRC section 1231 gain. If the asset was still held as inventory, then it would be considered ordinary income. The holding period begins at the date of the original distribution. IRC section 1223.

Proportionate Liquidating Distributions

The treatment of proportionate liquidating distributions is similar to current distributions. Gain is only recognized if money distributed (including relief of liabilities and FMV of marketable securities) exceeds the partner's basis in his partnership interest prior to the distribution. Additionally, the liquidating partner's outside basis is allocated among the distributed items in the same order (money, IRC section 751 assets, and other assets).

Because the partner is exiting the partnership, a liquidating distribution will always result in a zero outside basis. Since the partner receives his share of the partnership's value, a liquidating distribution will terminate the partner's interest in the partnership.

Recognition of Loss

Unlike current distributions, **losses** can be recognized from a liquidating distribution. **This can happen only if the partner receives no property other than money, unrealized receivables, or inventory**. In other words, the receipt of a capital asset will prevent the recognition of loss. The amount of any loss recognized is the difference between the partner's outside basis in his partnership interest before the distribution and the sum of money and the partnership's adjusted basis of distributed receivables and inventory.

Example 4-5

Lee's interest in the XYZ partnership is terminated when her outside basis is $100,000. She receives a liquidating distribution of $20,000 cash and inventory with a basis to the partnership of $70,000. She recognizes a loss of $10,000 ($100,000 partnership basis less $90,000 basis in assets received).

A loss is permitted in these types of circumstances because the basis of an IRC section 751 asset is never increased beyond the basis it had inside the partnership. Since the Code preserves the ordinary income potential of IRC section 751 assets, Lee's remaining partnership basis in the above example cannot be assigned to the inventory distributed. Therefore, she recognizes a capital loss upon the termination of her partnership interest. IRC section 741

Allocation of Basis Among Distributed Assets

The determination of basis in the distributed property in a liquidating distribution is somewhat different than in a current distribution because the partner is exiting the partnership and will no longer have any outside basis. In a liquidating distribution, the exiting partner is said to take a *substituted basis* in the property distributed. **Outside basis must be $0 after the distribution of property**.

After the liquidating partner's outside basis is allocated to cash and ordinary income assets, any remaining basis is allocated to other property received. The basis allocated to other distributed property can either be:

- Decreased when there is insufficient outside basis OR
- Increased when outside basis exceeds the inside basis of property distributed

A decrease can occur in either a current or liquidating distribution. The method for allocating a decrease in basis, defined in IRC section 732(c)(3), is the same for both current and liquidating distributions of property.

An increase in the basis of other non-IRC section 751 property will occur only in the context of a liquidating distribution. The remaining outside basis is first allocated to properties with unrealized appreciation. Any remaining outside basis is then allocated among all properties in proportion to their fair market values.

The following two examples illustrate the allocation of basis in distributed assets in a liquidating distribution.

Example 4-6

AB Partnership is completely liquidating. A and B are both equal partners. The partnership distributes to A the land, one-half of the unrealized receivables, and one-half the inventory. The partnership distributes to B all of the cash, one-half of the unrealized receivables, and one-half the inventory. These are proportionate distributions because both A and B both receive their pro rata share of the FMV of IRC section 751 property upon liquidation. The balance sheet is as follows:

	Basis	FMV
Cash	40	40
Unreal.Receivables.	0	20
Inventory	20	20
Land	80	40

	Outside Basis	
	A	B
Balance	70	40
Cash	0	40
Remaining Basis	70	0
Unreal. Receivables	0	0
Inventory	10	0
Remaining Basis	60	0
Land	60	0
Basis must be $0	0	0

Note: The ending outside bases for both A and B must be $0 because the AB Partnership is completely liquidating.

Note: If there was only one partner liquidating his or her interest from a partnership, the examiner would need to consider IRC section 736 rules relating to the retirement of a partner which is discussed in Chapter 7.

Consequences to Partner A:

- A recognizes no gain. The first item to consider is cash and there was no cash distributed to him in excess of his outside basis. IRC section 731(a). In addition, no loss is allowed because A was distributed a capital asset. Remember, the only time a loss is allowed is when the assets distributed to a partner consist of only cash, unrealized receivables, depreciation recapture, or inventory in complete liquidation of the partner's interest.

- The second category of distributed assets including unrealized receivables and inventory were distributed to A using the adjusted bases in the assets. This category is distributed out next because the tax law does not permit assets that are ordinary in character to be stepped-up in basis by the operation of IRC section 732(c). If there was a step-up in basis, less ordinary income would be reported upon a subsequent disposition of the assets. In this instance, A had sufficient basis to utilize the partnership's entire bases in these assets, in contrast to B who had to lower the bases in these assets due to a lack of outside basis. The law permits lowering the bases in these type of assets, but not increasing their bases.

- The remaining basis to A after considering cash, and ordinary income assets is only $60. The adjusted basis to the partnership for the land is $80. The entire remaining $60 outside basis is allocated to the land. A will take a substituted basis of $60 in the land. Upon a later disposition of the land, A will compute his gain or loss on the asset using the new substituted basis amount of $60.

Consequences to Partner B:

- B recognizes no gain. B received cash of $40. This did not exceed B's outside basis in his partnership interest so under IRC section 731(a) no gain is recognized. B only received cash, unrealized receivables, and inventory in the distribution so he is a candidate for a potential loss. However, one other requirement must be met to take a loss and that is B's outside basis must be more than the bases in the assets received. In this case, B does not receive a loss because his outside basis was not more than the bases in the cash, unrealized receivables and Inventory distributed.

- The second category of distributed assets including unrealized receivables and inventory were distributed to B using the adjusted bases in the assets. B has insufficient outside basis after receiving the cash distribution so B must take a substituted basis of $0 in the unrealized receivables and inventory.

- B was not distributed out any other assets because this was a pro rata distribution. B received the cash with a $40 FMV and A received the land with a $40 FMV.

Upon a later disposition of the assets by A or B, IRC section 735 will apply in the same way as in Example 4-4 for current distributions. It is important to note that the regular distribution rules described in this section are the only rules followed *unless* there is a disproportionate distribution of IRC section 751 assets (unrealized receivables, depreciation recapture, and inventory). When this occurs the treatment of the distribution is bifurcated between sale and exchange treatment and the regular distribution rule treatment. So the regular distribution rules described in this section are still the framework of a disproportionate distribution. In a disproportionate distribution there is just a portion carved out of the regular rules and treated under sale and exchange rules.

The following example reflects the increase in assets allocated according to the unrealized appreciation in the remaining assets. Remember this occurs when the partner's outside basis is larger than the inside basis of the partnership asset distributed in the liquidating distribution.

Example 4-7

Stewart, Rod, and Mike are equal 1/3 partners in a real estate development partnership. In complete liquidation of his interest, Stewart receives relief of liabilities of $1,000, a land lot (inventory) with a basis of $1,000, a sculpture that was in the lobby of one of the partnership's properties, and shares of XYZ Inc., a publicly traded company. The sculpture, purchased as an investment, has a fair market value of $9,000 and a basis of $3,000 (unrealized appreciation of $6,000). The share of XYZ Inc. have a basis of $1,000 and a fair market value of $3,000 (unrealized appreciation of $2,000). Assume that the distribution is a proportionate distribution.

Initial Allocation of Basis: Stewart has an outside basis of $16,000. After it is reduced for the relief of liabilities ($1,000), the basis of the inventory

($1,000), and the carryover bases of the other properties ($3,000 for the sculpture and the $1,000 for the stock), the excess remaining basis is $10,000.

Allocation of Remaining Basis: The excess remaining basis is first allocated to reduced unrealized appreciation. Therefore, the basis of the sculpture is increased by $6,000 and the basis of the stock is increased by $2,000. The remaining excess basis of $2,000 is allocated in proportion to the fair market value of the other properties. Thus, 75 percent of the remaining basis is allocated to the sculpture ($9,000/$12,000) and 25 percent is allocated to the stock ($3,000/$12,000). Thus the basis of the sculpture in Stewart's hands is $10,500 and the basis of the stock is $3,500.

As seen in the above example, the excess remaining basis is allocated solely to non-IRC section 751 assets. Even if the inventory (the land lot in this example) had an extremely high fair market value, its basis would not be increased.

The rules of IRC section 735 apply to liquidating distributions as well as current distributions. In Example 4-6, the distributed land lot, since it was inventory to the partnership, would carry an ordinary income taint in Stewart's hands for 5 years following the year of distribution.

Disproportionate Distributions will be discussed in the last section of this chapter. Liquidating distributions are also discussed in Chapter 7.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

Are there distributions reported on the Schedules K-1? The Schedule M-2 should also reflect any distributions. This will alert the examiner that there has been either a current or liquidating distribution. Does the Schedule K-1 reflect a cash distribution? If so then, cash received in excess of the partner's basis in his partnership interest is taxable under IRC section 731(a).

What type of property has been distributed? The changes in the assets and liabilities on the balance sheet should help in this identification. If there was a disproportionate amount of IRC section 751 property distributed in the transaction, there may be a gain that must be recognized. This is true if there is a partial liquidation or a complete liquidation.

Has there been a change in ownership on the Schedule K-1? If there has then there is a potential partial liquidation or complete liquidation.

Are losses being claimed from a current distribution or in a partial liquidation to a partner? Losses are not allowed in these instances.

Are losses being claimed from a liquidating distribution when the partner still holds another interest in the partnership? All interests must be liquidated before

losses may be taken. Check the Schedules K-1 for a limited and general partnership interest held by the same partner.

Are distributions under IRC section 752(b), debt relief, being considered in either a current or liquidating distribution? Debt relief is treated like money. Money received in excess of the partner's adjusted basis in his partnership interest results in a taxable gain. IRC section 731(a).

Were marketable securities distributed? These are also treated as money received. This could also result in a taxable gain.

Issue Identification

Review the partner's Schedule K-1 for any change in ownership, change in liabilities, and distributions of cash or property. This will alert the examiner to any potential taxable gains.

Compare the balance sheet at the beginning of the year with the end of the year. If there has been a distribution of assets, the examiner may be able to determine which category of assets was distributed.

Review the ending capital account on the Schedule K-1. If the ending capital account is zero, then a partnership interest was completely liquidated. Make sure the partner has no other interests in the partnership. All interests must be liquidated.

Request a calculation of the partner's outside basis to determine the consequences of the distribution.

Documents to Request

1. Partnership Agreement and any amendments
2. Prior and subsequent year partnership returns
3. Calculation of the partner's basis.
4. Calculation of built-in depreciation recapture
5. Copy of the partner's tax return for the year of distribution.

Interview Questions

1. Is the distribution a distribution in liquidation of a partner's interest under IRC section 731(a)(2) or payments to a retiring partner or a deceased partner's successor in interest under IRC section 736? Refer to Chapter 7 if this is the situation. There are differences in the two types of liquidations.

2. What type of property was distributed to the partner or partners?

3. Was the liquidating distribution pro rata or was there a disproportionate distribution regarding the IRC section 751 assets?

4. Was there any relief of liabilities?

Supporting Law

IRC, Subchapter K: section 702
section 731
section 732
section 733
section 734
section 735
section 741
section 751
section 752
section 754

IRC section 1223
Supporting regulation and specific regulations cited above.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

McKee, William S., Nelson, William F., and Whitmire, Robert L. Federal Taxation of Partnership and Partners, Boston MA: Warren Gorham & Lamont, publisher.

Cunningham, Laura E., Cunningham Noel B., The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnership

ISSUE: DISGUISED SALES

Definition

Examiners reviewing distributions from partnerships should be sensitive to the issue of disguised sales. An outflow of cash or property, which is labeled as a "distribution", could in substance be part of a sales transaction.

Example 4-8

John contributes land with a fair market value of $150,000 and a basis of $100,000 to his partnership. In the same year, the partnership distributes $100,000 of cash and marketable securities worth $50,000 to John. John would not have contributed the land in the absence of the expected

distribution. The substance of this transaction is a sale and not a tax-free contribution and distribution of property.

As illustrated above, the disguised sales rules apply to situations where property – not only cash – is distributed to a partner in connection with property contribution by that partner.

IRC section 707(a)(2)(B), the disguised sales provision, was enacted as part of the Tax Reform Act of 1984. Congress believed that transactions that were the economic equivalent of sales were being treated as nontaxable contributions and distributions under IRC section 721 and IRC section 731.

IRC section 707(a)(2)(B) provides that:

- If a partner transfers money or property to a partnership and receives money or property in return, and
- Viewed together, both transfers are properly characterized as a sale or exchange,
- Then the transfers are treated as a sale of the property to the partnership

The enactment of IRC section 707(a)(2)(B) and related regulations seek to clarify which contribution/distribution transactions will be viewed as substantive sales.

Identifying a Disguised Sale

Obviously not all contributions followed by distributions are disguised sales. Whether or not the transaction is a disguised sale or a legitimate contribution/distribution depends on all the facts and circumstances. Care should be given to fully develop all aspects of the case.

The regulations finalized in 1992 under IRC section 707(a) provide a two-part test for determining when a transaction should be recharacterized as a sale.

Two-Part Test**:**

1. **"But for Test"** ─ The partnership would not have transferred money or property to the partner **BUT FOR** the transfer of the property by the partner to the partnership;

2. **"Facts and Circumstances Test"** -- When the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership's operations.

Thus, for a simultaneous transfer, there is really only one condition. The examiner is faced with analyzing whether or not the money or property transferred to the partner would have happened regardless of the partner's contribution. Additionally, in analyzing non-simultaneous transfers, the examiner is faced with documenting the nature of the business and the level of risk connected with whether or not the partner would be "paid".

It is also possible that the contribution/distribution transaction should be recharacterized as a partial sale and partial contribution.

Example 4-9

Kelly, a scientist, contributes a patent he developed to XYZ Pharmaceutical Partnership in exchange for a partnership interest. At the time of the contribution, Kelly could have sold the patent to XYZ for $5 million. Kelly has a $1 million adjusted basis in the patent. On the date of the contribution, XYZ distributes $2 million to Kelly. The distribution was agreed to in advance.

Result:

- Because the cash Kelly received was less than the fair market value of the patent, the transaction is in substance a partial sale and a partial contribution. The portion of the property sold is equal to the ratio of the cash received over the fair market value of the property transferred. In this case, 40 percent of the patent was sold and 60 percent was contributed.

- Consequences to the Partner:
  1. Basis in property sold = $400,000 (40 percent of original basis)
  2. Gain on sale = $1,600,000 ($2,000,000 - $400,000)
  3. Basis of contributed property = $600,000
  4. Basis of partnership interest = $600,000

- Consequences to the Partnership:
  1. The patent's inside basis is $2,600,000 ($2,000,000 sales price plus $600,000 basis in contributed property).

In the above example, the gain could not be properly calculated without knowing the fair market value of the patent. In such situations, the examiner would make an engineering referral.

Ten Factors

Fortunately, the regulations list ten primary but non-exclusive factors that should be considered in determining whether or not there was a sale:

1. The certainty of the timing and amount of the second transfer;
2. Whether or not the second transfer is legally enforceable;
3. Whether or not the second transfer is secured in any way;
4. Whether a third party is obligated to make a contribution to the partnership to enable it to make the second transfer
5. Whether a third party is obligated to make a loan to the partnership to enable it to make the second transfer
6. Whether the partnership has incurred, or is obligated to incur, debt to enable it to make the second transfer

7. Whether the partnership has excess liquid assets that are expected to be available for the second transfer
8. Whether the partnership distributions, allocations, or control of operations are designed to effect an exchange of the benefits and burdens of the ownership of the contributed property;
9. Whether the amount of the distribution to a partner is disproportionately large in relation to his general and continuing interest in partnership profits;
10. Whether the partner has no or minimal obligation to return distributions to the partnership.

Treas. Reg. section 1.707-3(b)(2).

Two Year Presumption

The timing of the potentially related contribution and distribution is critical. The regulations describe two presumptions to be considered:

Presumptions

- **"Within 2years" -** Transfers that occur within 2 years of each other are presumed to be sales unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

- **"More than 2 years" -** Transfers that are made more than 2 years apart are presumed not to be a sale unless the facts and circumstances clearly establish that a sale took place.

In sum, the examiner is to determine if the partner's contribution was placed at the risk of the venture or if the contributing partner was "cashing out". Of course, the partnership could be the party "cashing out" by distributing property to the partner in exchange for payment disguised as a contribution.

Exceptions to the Two-Year Presumption: "Normal Distributions"

Certain types of distributions or payments are presumed not to be part of a disguised sale even though occurring within a 2 years of a contribution. To protect "normal" periodic partnership distributions from falling within the scope of IRC section 707(a)(2)(B), the following types of payments do not trigger the two-year presumption:

1. Distributions from normal operating cash flow
2. Reasonable guaranteed payments
3. Preferred returns intended to compensate partners for the use of their capital
4. Reimbursements of preformation expenditures

Liabilities

As explained in Chapter 3, when a partner's share of partnership liabilities decreases, it is considered to be a deemed distribution of money. A partner who

contributes mortgaged property will have such a distribution when the other partners pick up a share of the contributed liability.

Any liabilities that are not considered **qualified liabilities** may constitute the proceeds of a disguised sale. A qualified liability is one that is not incurred "in anticipation of the transfer". On the other hand, a **nonqualified liability** is one which was incurred in anticipation of transferring the property to the partnership and is a device used by the partner to "cash out" his investment in the contributed property. The portion of the nonqualified liability shifted from the contributing partner to the other partners constitutes payment for a disguised sale.

Qualified Liabilities

There is a conclusive presumption that a liability is qualified if it was incurred more than 2 years prior to the transfer of the property to the partnership. These liabilities are thought to be "old and cold" and outside the scope of the disguised sales rules. Conceivably, with planning and foresight, a taxpayer could create a "legal" disguised sale. Treasury has, at any rate, concluded that these types of liabilities were probably not incurred in anticipation of the transfer of the property to a partnership.

If a liability was incurred within 2 years of the transfer, it could still be considered to be qualified depending on the use of the proceeds of the debt. First, if the proceeds were used to acquire or improve the contributed property, the liability is still qualified. This is because the contributing partner has used the loan proceeds to increase his or her investment rather than cashing out. Second, if the liability is incurred in the ordinary course of the business and substantially all of the business assets are contributed to the partnership, the liability is still qualified. This rule addresses trade payable and other liabilities whose purpose is not to cash out the contributing partner's interest in the property.

Nonqualified Liabilities

A nonqualified liability is fully subject to the disguised sales rules. If a liability was incurred less than 2 years before transferring the property, it is presumed to be a nonqualified unless the facts and circumstances indicate that it was not incurred in anticipation of the transfer.

Under the disguised sales rules, the contributing partner is treated as having an amount realized equal to the amount that was shifted away to other partners under IRC section 752(b). This is the excess of the total liability contributed over the contributing partner's remaining share of the liability post-contribution. Thus, to determine the amount realized, it is necessary to apply the rules under 752 to determine the post-contribution debt share.

In the case of recourse liabilities, the normal rules under IRC section 752 apply. For non-recourse liabilities, the first two tiers listed in 1.752-3 are ignored and only the third tier, excess non-recourse liabilities are taken into consideration. Excess non-recourse liabilities are generally shared based on profit sharing. Thus, for

determining the amount realized under IRC section 707(a)(2)(B), a partner's share of non-recourse debt is computed in the same manner as "excess recourse liabilities," that is, based on profit share.

Disguised Sales of Partnership Interests

Although the previous discussion has focused on disguised sales of property, a contribution and related distribution could also pertain to the disguised sale of a partnership interest.

Disclosure Requirements

For certain transfers that are presumed to be sales, the partnership and the partners must comply with the disclosure requirements found in Treas. Reg. section 1.707-8.

Examination Techniques

Scrutinize any distributions of cash or property from the partnership, separating "normal distributions" per Treas. Reg. section 1.704-1

Inspect previous years' tax returns and Schedules K-1 for evidence of a contribution from the same partner who received a distribution

Review the partnership agreement, amendments, and any correspondence pertaining to the contribution and the distribution

Document the timing of the contribution and distribution

Issue Identification

Does the Schedule K-1 or the Schedule M-2 reflect a contribution or a distribution? If it does then request what property was contributed or distributed? All factors will need to be considered if there was a disguised sale.

If there was a contribution or a distribution, were there liabilities involved? Determine if they were nonqualified liabilities that would result in a disguised sale.

Review the 10 factors to consider if there is a disguised sale present. Be prepared to ask questions according to these factors to develop the facts and circumstances surrounding any contribution and subsequent distribution.

Documents to Request

1. Partnership Agreement and any amendments
2. Correspondence relating to the contribution or distribution
3. Documents relating to the dates of contribution and distribution

4. Request a basis calculation to determine if there is a trend of normal distributions from year to year or is this an unusual transaction
5. Request any loan documents involved to determine if the liabilities are qualified or nonqualified.

Interview Questions

Interview questions should be designed to answer the following questions:

1. Did the contributing partner risk anything by contributing the property to the partnership, or did the partner essentially close out his economic interest in the property?
2. What factors indicate that the contribution and the distribution are related?
3. What factors indicate that the distribution would have occurred in any event, and was not dependent on the success of the partnership's business?
4. After the distribution, who bore the benefits and burdens of the contributed property?
5. What was the business purpose for the contribution and distribution?

Supporting Law

IRC, Subchapter K: 707(a)(2)(B)

Supporting regulation and specific regulations cited above including the following:

General Rules	Treas. Reg. section 1.707-3
"Normal" Distributions	Treas. Reg. section 1.707-4
Special Rules for Liabilities	Treas. Reg. section 1.707-5
Sales by Partnership to Partner	Treas. Reg. section 1.707-6

Note: Final regulations apply to transactions occurring after April 24, 1991.

Otey v. Commissioner, 70 TC 312 (1970), ***Jupiter Corporation v. United States***, ***Park Realty Co. v. Commissioner***, ***and Communications Satellite Corporation v. United States***. Prior to the enactment of 707(a)(2)(B), IRS unsuccessfully attempted to recharacterize transactions as disguised sales.

Goudas v. Commissioner, T.C. Memo 1996-555, ***aff'd***, 137 F.3d 368 (6th Cir. 1998), the taxpayer was a 25 percent partner in the Pecaris Partnership which owned a shopping mall. The taxpayer formed Coastal Investments Partnership in which he was a 90 percent partner. The Pecaris Partnership sold the shopping mall to Coastal Investments and reported the transaction as a sale. The taxpayer did not report his 25 percent distributive share of the gain on his individual return. Instead, he characterized the transaction as a nontaxable distribution of a 25 percent undivided interest in the mall followed by a nontaxable contribution of the 25 percent interest to Coastal.

The taxpayer did not inform the other Pecaris partners of his 90 percent interest in the purchasing partnership. Neither the Pecaris tax return nor the partnership

agreement reflected a distribution of an interest in the mall to the taxpayer. The court refused to recharacterize the taxpayer's share of the gain as a nontaxable distribution of an interest in the mall.

ISSUE: DISTRIBUTIONS OF PROPERTY WITH BUILT-IN GAIN OR LOSS

In certain situations, distributions of IRC section 704(c) property to a noncontributing partner will cause the partner who contributed the property to recognize gain. As explained in Chapter 3, section 704(c) property is property that had a built-in gain or loss at the time of its contribution to the partnership.

Under IRC section 704(c), gain or loss inherent in contributed property must be allocated back to the contributing partner when the property is sold, or over time as depreciation or amortization deductions are allocated away from the contributing partner. Prior to October 3, 1989, IRC section 704(c) could be circumvented simply by distributing the section 704(c) property rather than selling it. Therefore, Congress established IRC section 704(c)(1)(B) to eliminate the inconsistent treatment between sales and distributions of section 704(c) property.

Distribution Treated as a Sale

If section 704(c) property is distributed within a **7 year period** to any partner other than the contributing partner, IRC section 704(c)(1)(B) treats the distribution as if it were a sale taking place on the date of the distribution. This forces the contributing partner to recognize any gain that was inherent in the property at the time of its contribution to the partnership and alters the inside basis of the property prior to its distribution. Others partners are not affected by the deemed sale.

Example 4-10

Biotech Corporation and Giant Pharmaceuticals Inc. form a partnership on January 1, 1999. Biotech contributes a patent for Drug X which has a basis of $2 million and a FMV of $10 million. Giant Pharmaceuticals Inc. contributes its own stock, which has a value of $20 million. On January 15, 1999, the patent is distributed to Giant Pharmaceuticals.

In the above example, Biotech has in substance exchanged its patent for an undivided 50 percent interest in a partnership. Note that the disguised sales rules under IRC section 707 would not apply in this case because Biotech did not receive a distribution. Nonetheless, it essentially sold its patent for $10 million of Giant Pharmaceutical stock.

IRC section 704(c)(1)(B) prevents partners from engaging in swaps through a partnership that would not qualify for section 1031 like-kind treatment outside the partnership. In this case, the distribution of the patent would be

treated as a sale and Biotech would realize gain of $8 million. Biotech's capital account would be increased by $8 million and the partnership would also increase its basis in the patent by that amount. Thus, Giant Pharmaceutical's basis in the distributed patent would be $10 million under IRC section 732 and not $2 million.

By triggering gain recognition to Biotech, IRC section 704(c)(1)(B) has not only prevented income shifting from Biotech to Giant (the gain that had accrued on the patent in Biotech's hands), but also the deferral of gain. If IRC section 704(c)(1)(B) were not in effect, Giant could manufacture Drug X under the patent indefinitely, and the gain might never be taxed, in spite of the fact that Biotech closed out its economic position in the patent.

Seven Year Period

It is important to bear in mind that the provision only applies to distributions made within the 7 year period, which is the 7 years following the contribution of the built-in gain or loss property. With this in mind, the examiner must be especially sensitive to considering and documenting the origins of distributed property. The original partnership agreement and its amendments are critical in determining what property was contributed.

The time period, which was originally five years, was extended to seven years for property contributed to a partnership after June 8, 1997.

Calculation of Gain or Loss

The gain or loss allocated to the contributing partner is the same amount that would be allocated under IRC section 704(c)(1)(A) and Treas. Reg. section 1.704-3 had the partnership sold the property to the distributee partner for its fair market value on the date of the property's distribution. Thus, the contributing partner will recognize the lesser of:

- The built-in gain or loss inherent in the property at time of contribution OR
- The gain or loss that would be allocated to the contributing partner if the partnership sold the property to the distributee for its fair market value

Example 4-11

Chris contributes north land lot and south land lot to an equal partnership formed with Diane. Both land lots have a basis of $40 and a fair market value of $100. Diane contributes $200 cash. Both land lots are IRC section 704(c) property because they each have a built-in gain of $60. The partnership uses the cash to subdivide the lots.

After 3 years, when it is worth $150, the north land lot is distributed to Diane. Chris, the contributing partner must recognize the lesser of:

- $60,The property's built-in gain or loss at time of contribution, OR
- $85, the amount that the contributing partner would recognize had the partnership sold the property for its fair market value (built-in gain of $60 plus half of the $50 gain that accrued in the hands of the partnership

Thus, Chris would recognize a $60 gain upon the distribution. The gain would increase both her outside basis and the inside basis of the north land lot just prior to its distribution. Thus, Diane's basis in the land would be $100.

Example 4-12

Same facts as the above example, except that on the date of distribution the north land lot has a fair market value of $60. The hypothetical sale would therefore produce a tax gain of $20 (sales price of $60 less adjusted tax basis of $40) and a book loss of $40 (sales price of $60 less book basis of $100).

Under the Methods described Chapter 3, the following would result:

- Under the traditional method, Chris would be allocated a $20 gain
- Under the remedial method, a tax loss of $40 would be allocated to Diane to match her book loss. As a result, $40 of gain would be allocated to Chris as an offsetting remedial allocation. Therefore, Chris would recognize a $60 gain, consisting of $20 of 704(c) gain and $40 of remedial gain.

Exception for Like-Kind Exchanges

Since the aim of the provision is to prevent a partner from closing out an economic position in contributed property without recognizing gain, it makes sense that an exception should apply for situations that would qualify for the like-kind exchange rules. If, within a certain time period of distributing the IRC section 704(c) property, the partnership also distributes like-kind property to the contributing partner, the contributing partner will be treated as having engaged in an IRC section 1031 exchange and not a sale. The amount of gain or loss that the contributing partner would normally recognize under IRC section 704(c)(1)(B) is reduced by the amount of built-in gain or loss in the distributed like-kind property.

De Minimis Rule

A partnership may disregard the application of IRC section 704(c) if the fair market value of the contributed property does not differ from the tax basis by more than 15 percent of the adjusted tax basis, and the total gross disparity does not exceed $20,000. Treas. Reg. section 1.704-3(e).

Anti-Abuse Rule

An anti-abuse rule is found in Treas. Reg. section 1.704-4(f). It states that if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of IRC section 704(c)(1)(B), the Commissioner can recast the transaction for federal income tax purposes. This prevents the contributing partner from closing out his or her economic position in the distributed property prior to the end of the 7 year period, but before the distribution actually takes place.

In Example One in Treas. Reg. section 1.704-4(f)(2), the partners amend the partnership agreement during the 7 year period and "take steps to provide that substantially all of the economic risks and benefits" of the contributed property are borne by the future distributee partner. Thus, before the actual distribution, the future distributee essentially owns the property. In such a situation, IRC section 704(c)(1)(B) would call for the contributing partner to recognize gain on the date that the economic risks and benefits of the contributed property are transferred to the future distributee.

To ensure consistent application, examiners should involve one of the national Partnership Technical Advisors before proposing an adjustment based on the anti-abuse rule in Treas. Reg. section 1.704-4(f).

Examination Techniques

Determine if there has been a distribution of property to a partner. Request a schedule of contributions that have been made by the partners in the last 7 years. If the distributed property is IRC section 704(c) built-in gain property then ensure that the contributing partner has recognized the inherent gain in the property. This rule applies only if the property has been distributed to a different partner than the original contributing partner. If this property is being distributed back to the partner that originally contributed it, then this rule does not apply.

Issue Identification

Scrutinize the Partnership Schedule M-2 and the Schedules K-1 for any distributions during the partnership year.

Review prior year's partnership returns and Schedules K-1. If there was IRC section 704(c) depreciable property present then the Schedules K-1 and the M-1 should reflect a special allocation of the depreciation using one of the methods described in Chapter 3 relating to IRC section 704(c) principles. This will alert the examiner to the fact that IRC section 704(c) property does exist within the partnership.

Documents to Request

1. Partnership Agreement and any amendments
2. Correspondence relating to a distribution
3. Documents relating to the dates of contributions and distributions

4. Request the prior and subsequent year returns for the partnership including the Schedules K-1.
5. Request a schedule of contributions that have been made in the past 7 years.
6. Request the basis calculation of all of the partners, if the examiner suspects there was an IRC section 704(c)(1)(B) transaction. This will allow the examiner to determine which partner contributed the property and which partner was distributed the property.
7. Request the contributing partner's Form 1040 to make sure there has been a taxable gain reported if there is an IRC section 704(c)(1)(B) transaction present.
8. Request the calculation of the gain that should be recognized by the contributing partner.
9. Request a FMV appraisal of the IRC section 704(c) property.

Interview Questions

1. Was there a distribution of property during the year?
2. What property was distributed? Was the property previously purchased or contributed by another partner? If it was contributed by another partner then IRC section 704(c) principles rules may need to be applied, if the property was built-in gain or loss property.
3. Was there a FMV appraisal of the property at the time of the contribution and at the time of the distribution to determine any built-in gain or loss or gain recognition?
4. When was the property originally contributed? When was the property actually distributed?
5. Were there any like-kind exchanges that fall under the IRC section 704(c)(2)(B) rules?

Supporting Law

IRC, Subchapter K: section 704(c)(1)(B)

Supporting regulations and specific regulations cited above including Treas. Reg. section 1.704-4.

Resources

Cunningham, Laura E. & Cunningham, Noel B., The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships, St. Paul, MN: West Publishing Co., publisher.

ISSUE: DISTRIBUTION OF PROPERTY TO CONTRIBUTING PARTNER

A contributing partner could accomplish the sale of appreciated property by having the partnership distribute other property to "cash out" the partner's interest in the property contributed.

Example 4-13

Carmen, a real estate developer, contributes a parcel of land to Development Partnership. The land has a fair market value of $250,000 and a basis of $100,000. Three years later, when the land is still worth $250,000, the partnership distributes heavy equipment worth $250,000 to Carmen. Assume the distribution is a pro rata distribution. Even though Carmen has closed out her economic interest in the land, she does not report any gain.

IRC section 737 was enacted to prevent this type of transaction.

Under IRC section 737, if a partner receives other property within a 7-year period of contributing appreciated property, gain, but not loss, may be recognized. IRC section 737 assumes that the distributee partner is effectively "selling" any appreciated property that was contributed during the previous seven years.

For property contributed on or before June 8, 1997, the period during which a distribution can trigger gain to the contributor is 5, rather than 7 years.

Effect of IRC section 751 and IRC section 731

Gain recognized under IRC section 737 is in addition to any gain recognized under IRC section 731. Thus, a distribution could result in gain recognized under both IRC section 731 and IRC section 737.

IRC section 737 does not apply to a distribution to the extent that section 751(b) applies. Thus, it is important for the examiner to determine whether or not the distribution upsets the partner's proportionate share of IRC section 751 and non-IRC section 751 assets. If the distribution is not pro-rata, then IRC section 751(b) should be addressed before IRC section 737. Additionally, IRC section 737 does not apply to deemed distributions of property caused by technical terminations under IRC section 708(b)(1)(B).

Amount of Gain

The gain will equal the lesser of:

- The amount by which the fair market value of the property received exceeds the adjusted tax basis of the partnership interest reduced by any money received, OR
- The partner's "net precontribution" gain

The net precontribution gain is the <u>total</u> amount of built-in gain that the partner has in all property that was contributed, and is still held by the partnership, during the 7 years prior to the distribution.

The examiner would have to scrutinize the asset side of the balance sheet and all partnership amendments over a 7-year period in order to establish the correct amount of net precontribution gain at the date of distribution.

For depreciable or amortizable property, it is important to remember that the partnership is required to follow IRC section 704(c) principles to reduce the disparity between the property's book value and tax basis. Therefore, the amount of the net precontribution gain declines over time.

Example 4-14

On January 1, 1995, John contributes land which is dealer property with a $50,000 basis and a fair market value of $100,000 to the Development Partnership. On January 1, 1997, he contributes dealer property, with a $80,000 basis and a fair market value of $120,000. On January 1, 1999, he receives a distribution of a warehouse whose fair market value is $300,000. Since partnership operating income exactly matched distributions for the year, John's outside basis is remains at $130,000 ($50,000 and $80,000).

John's precontribution gain on January 1, 1999, is $90,000 ($50,000 from the first land contribution and $40,000 from the second). The value of the warehouse exceeded his outside basis by $170,000 ($300,000 FMV less outside basis of $130,000). Since his precontribution gain is less than the excess distribution of $170,000, he will recognize $90,000 upon receiving the warehouse.

As shown in the following example, gain recognized under IRC section 737 is in addition to any gain recognized under IRC section 731:

Example 4-15

Same facts as in the above example, except that partnership losses have reduced John's basis to $10,000. On January 1, 1999, John receives $15,000 of cash and the warehouse from the partnership. John's basis is reduced to zero and he recognizes $5,000 of IRC section 731 gain (cash distribution in excess of basis). Additionally, he recognizes $90,000 of IRC section 737 gain, since the amount of his precontribution gain is less than the fair market value of the property distributed ($300,000) less outside basis ($0 after the cash distribution)

Basis Adjustments

The outside basis of the partner subject to IRC section 737 will be increased by the amount of gain recognized. The increase in not taken into account for determining the amount of any gain recognized under IRC section 731. It is, however, taken into account for determining the basis in the property received. The basis of the distributed property is determined under the normal rules of IRC section 732(a) or IRC section 732(b). Additionally, the partnership increases its basis in eligible property by the amount of gain recognized by the partner subject to IRC section 737.

Example 4-16

Same facts as in Example 4-15. John's basis in his partnership interest is increased by $90,000, the amount of gain recognized under IRC section 737. His total outside basis is therefore $220,000 ($130,000 plus $90,000). If the partnership's basis in the warehouse were $200,000, John would take a carryover basis of $200,000 and his outside basis in his partnership interest would be reduced to $20,000.

Additionally, as shown in the next example, the partnership increases its basis in eligible property by the amount of gain recognized by the partner subject to IRC section 737. Eligible property is defined in Treas. Reg. section 1.737-3(c)(2) and includes the property that entered into the calculation of the distributee partner's net precontribution gain. The basis increase is allocated among the eligible properties in the order in which the properties were contributed to the partnership by the partner. Starting with the first contributed property, basis is allocated in an amount equal to the difference between the property's fair market value and adjusted basis at the time of the distribution.

Example 4-17

Same facts as in Example 4-15. The values of the two properties contributed by John in 1995 and 1997 have remained the same. The partnership increases the basis of the first property by $50,000 and increases the basis of the second property by $40,000.

Distribution of Previously Contributed Property

To the extent the distributee partner receives back property previously contributed, the precontribution gain associated with that property is not taken into consideration in calculating the partner's net precontribution gain. In this situation, the partner would be "cashing out". This rule, however, cannot be used to avoid IRC section 737 by increasing the value of a contributed entity that is then distributed back to the contributing partner.

Example 4-18

Same facts as in Example 4-13, except that in addition to contributing land, Carmen also contributes all of the stock of her closely held real estate development corporation. The partnership contributes the heavy equipment to the corporation in a nontaxable IRC section 351 exchange. Three years later, the partnership distributes all of the stock to Carmen. Assume that it is a pro rata distribution. In this situation, IRC section 737 would apply and Carmen would recognize gain of $150,000.

Character of the Gain

The character of the gain recognized depends on the character of the net precontribution gain. Precontribution gains and losses are netted according to their character. The character of a net negative amount is disregarded.

Example 4-19

Carmen, a real estate developer, contributes Parcel A, Parcel B, and $5,000 of Internet Inc. stock to an Investment Partnership. Parcel A has a tax basis of $10,000 and a fair market value of $20,000. Parcel B has a tax basis of $10,000 and a fair market value of $5,000. Internet Inc. stock has a tax basis of $50,000.

Parcel A and Parcel B were inventory in Carmen's hands. Parcel A had a built in gain of $10,000 and Parcel B had a built-in loss of $5,000. Therefore, Carmen has $5,000 of net ordinary precontribution gain. The $45,000 built-in capital loss from the Internet Inc. stock is disregarded since it is a net negative amount. Therefore, the character of any distribution to Carmen to which IRC section 737 would apply would be ordinary.

Anti-Abuse Rule

An anti-abuse rule is found in Treas. Reg. section 1.737-4. It states that if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of IRC section 737, the Commissioner can recast the transaction for federal tax purposes.

Example One in Treas. Reg. section 1.737-4(b) addresses a situation in which a partner contributes additional property in order to increase his adjusted tax basis in the partnership interest for purposes of calculating the excess distribution. The goal is to create a situation in which the adjusted basis of the partnership interest is greater than the fair market value of the property distributed. In this case, there would be no IRC section 737 gain since there would be no excess distribution. The key words in the example are that "steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A".

In the example, A, the contributing partner, retained all of the benefits and burdens of ownership of the property. Since there was no bona-fide contribution, the transaction would be recast for federal income tax purposes.

In Example Two, the partners also desire to avoid IRC section 737 gain. The distributee partner in this example increases his basis by assuming the partnership's recourse liability. As a result of the liability shift, the distributee partner's adjusted tax basis in his partnership interest is greater than the fair market value of the property distributed and no IRC section 737 gain is recognized.

The key sentence in this example is "The $10,000 recourse liability is a bona-fide liability of the partnership that was undertaken for a substantial business purpose and A's and B's agreement that A will assume responsibility for repayment of that debt has substance."

As seen in these two examples, the substance over form doctrine takes center stage. In the first example, the contribution that increased the basis in the partnership interest was bogus; in the second example, the increase in partnership basis was respected because the contributing partner assumed the risk of repayment of bona-fide partnership debt.

In order to ensure consistent application, examiners should involve one of the national Partnership Technical Advisors before proposing an adjustment based on the anti-abuse rule found in Treas. Reg. section 1.737-4.

Examination Techniques

Determine if there has been a distribution of property to a partner. Request a schedule of contributions that have been made by the partners in the last 7 years. Determine if the distributed property is IRC section 704(c) built-in gain property.

Issue Identification

Scrutinize the Partnership Schedule M-2 and the Schedules K-1 for any distributions during the partnership year.

Review prior year's partnership returns and Schedules K-1. If there was IRC section 704(c) depreciable property present then the Schedules K-1 and the M-1 should reflect a special allocation of the depreciation using one of the methods described in Chapter 4 relating to IRC section 704(c) principles. This will alert the examiner to the fact that IRC section 704(c) property does exist within the partnership.

Documents to Request

1. Partnership Agreement and any amendments
2. Correspondence relating to a distribution
3. Documents relating to the dates of contributions and distributions
4. Request the prior and subsequent year returns for the partnership including the Schedules K-1.
5. Request a schedule of contributions that have been made in the past 7 years.
6. Request the basis calculation of the partner that contributed property and was distributed property back in a 7-year period, if the examiner suspects there was an IRC section 737 transaction.
7. Request the contributing partner's Form 1040 to make sure there has been a taxable gain reported if there is an IRC section 737 transaction present.

8. Request the calculation of the gain that should be recognized by the contributing partner.
9. Request a FMV appraisal of the IRC section 704(c) property.

Interview Questions

1. Was there a distribution of property during the year?
2. What property was distributed? Was other appreciated property previously contributed by the partner receiving the property?
3. Was there a FMV appraisal of the property at the time of the contribution?
4. When was the property originally contributed? When was the property actually distributed? Determine if it was within 7 years.

Supporting Law

IRC, Subchapter K: section 737

Supporting Regulations and specific regulations cited below:

Recognition of precontribution gain	Treas. Reg. section 1.737-1
Exceptions and special rules	Treas. Reg. section 1.737-2
Basis adjustments	Treas. Reg. section 1.737-3
Anti-Abuse rule	Treas. Reg. section 1.737-4

Resources

Cunningham, Laura E. & Cunningham, Noel B., The logic of Subchapter K: A Conceptural Guide to the Taxation of Partnerships, St. Paul, MN: West Publishing Co., publisher.

White, Stephen J. et al, Avoiding the Application of Section 737, The Journal of Partnership Taxation, Fall 1993

Cuff, Terence Floyd, The Anti-Abuse Rule and the Basis Rules of the Final Section 737 Regulations, The Journal of Partnership Taxation, Spring 1997

ISSUE: DISPROPORTIONATE DISTRIBUTIONS

A distribution is disproportionate if a partner receives more or less than his or her pro rata share of IRC section 751 property. Disproportionate distributions, which can occur in either current or liquidating distributions, are treated as sales or exchanges. The purpose of treating a portion of the distribution as a sale or exchange is to prevent the partners from converting ordinary income into capital gain. IRC section 751 addresses income characterization rather than income shifting.

This chapter will discuss disproportionate distributions as they relate to complete liquidation of a partner's interest in a partnership. However, the IRC section 751(b) rules relate to partial liquidations (current distributions), as well. See Treas. Reg. section 1.751-1(g), Example 5 for the application of these rules in a partial liquidation situation.

Identification of IRC section 751 "Hot Assets"

The identification of IRC section 751 assets is critical to both the sale or exchange of a partnership interest, a partner receiving retirement payments for property under IRC section 736(b) (Chapter 8), and disproportionate distributions. Under the IRC section 751 regime, hot assets fall into two categories:

- Unrealized receivables of the partnership
- Inventory

Although this appears to be fairly straightforward, a degree of complexity lurks behind these simple terms. It is important to note that money, including the relief of liabilities, is **not** a 751 asset.

Unrealized Receivables

Unrealized receivables, as defined in IRC section 751, encompass much more than the receivables of a cash basis taxpayer. Unrealized receivables include any right to be paid for services or goods which are not capital assets. ***In Logan v. Commissioner,*** 51 T.C. 482 1968, the tax court determined that unbilled fees for a law firm's work in progress fell within the definition of IRC section 751(c). The court rejected the taxpayer's argument that because there were no express agreements between the partnership and its clients there was no right to payment. Pointing out that had Logan stayed in the partnership, he would have received ordinary income, the court commented that "The fruit petitioner left on the partnership tree may not have been ripe, but it was nonetheless fruit."

Partnership contracts representing the right to be paid for future services rendered or goods delivered can also fall within 751(c). In ***Roth v. Commissioner***, 321 F.2d 607 (9th Cir. 1963), ***aff'g.*** 38 T.C. 171 (1962), a partnership which produced a movie gave Paramount Pictures Corp. 10-year distribution rights in exchange for a percentage of gross receipts. The court determined that the partnership's rights to payments under the contract constituted an unrealized receivable.

In ***Hale v. Commissioner***, T.C. Memo 1965-274, a withdrawing partner received real property and a promissory note in exchange for his partnership interest. One of the partnership's remaining assets was the right to share in future profits of a real estate development company, conditioned on the partnership's promise to render future services. The court held that the right to future income was an unrealized receivable because it was based on an obligation to render future services.

The term unrealized receivables also covers potential depreciation recapture.

Inventory

Prior to the Taxpayer Relief Act of 1997, the inventory of the partnership as a class had to be "substantially appreciated" to come within the definition of a IRC section 751 asset. The 1997 Act eliminated this requirement for sales of partnership interests but not for disproportionate distributions. For purposes of selling a partnership interest, all inventory is considered to be within the scope of IRC section 751. For disproportionate distributions, the inventory must still be "substantially appreciated."

Inventory items are considered to have appreciated substantially if their fair market value exceeds 120 percent of the partnership's adjusted basis. Since the determination is made based on total inventory, partners could obviously circumvent this rule by simply purchasing additional (unappreciated) inventory. IRC section 751(b)(3)(1)(B) aims to prevent any manipulation of the inventory fair market value calculation. If inventory is purchased with a principal purpose of escaping IRC section 751, it will be excluded from the calculation of the total inventory's fair market value.

Identifying a Disproportionate Distribution

To determine if a pro rata share of partnership property was distributed, the FMV of the all partnership assets is considered instead of the bases in these assets. In order to fall within the regular pro-rata distribution rules described in the above sections on current and liquidating distributions, *** each partner's share of IRC section 751 assets and other property (including cash) must remain unchanged after the distribution. When the partner's share of the partnership's IRC section 751 and non-IRC section 751 assets is altered, the rules under IRC section 751(b) come into play. The examiner, therefore, must be able to document the type and fair market value of the partnership's assets and the type and fair market value of the assets distributed.

Note: It is important to keep in mind that when a partner receives relief of debt and nothing else from the partnership in a liquidating distribution, that this is considered cash. If there are any IRC section 751 assets, including depreciation recapture that would be part of a building that is held by the partnership, then there would be a disproportionate distribution.

<u>Conceptual Overview</u>

IRC section 751(b) divides the distribution into two parts:

1. These rules carve out the non-pro rata portion of the distribution that is disproportionate and treats it under sale and exchange rules. This is called the "deemed distribution" and the "deemed exchange." Both the deemed distribution and the deemed exchange have all of the tax consequences of a true distribution and sale. The normal sale and exchange code sections apply

to this portion including IRC section 1231, IRC section 1001(b) and (c), and IRC section 1011.

2. The remaining distribution that continues to be pro rata will follow the regular distribution rules explained in detail above. IRC section 731 through IRC section 735 will continue to apply here.

The purpose of treating a portion of the distribution as a sale or exchange is to prevent the partners from converting ordinary income into capital gain as stated before. It ensures that after a distribution that each partner will eventually report his share of ordinary income from the IRC section 751 property that was held in the partnership immediately before the distribution. In this way, the partners cannot shift ordinary income to either the distributee partner, if he was to receive excess IRC section 751 property, or back to the partners remaining in the partnership, if they kept excess IRC section 751 property.

The 751(b) regulations provide the mechanism as to how the portion of the distribution subject to the sale or exchange treatment operates. The following occurs:

1. If the distributee partner receives **more than** his or her share of IRC section 751 property, then he or she is "deemed" to have sold or given up his or her share of Non -IRC section 751 property for IRC section 751 property

2. If the distributee partner receives **less than** his or her share of the IRC section 751 property then he or she is "deemed" to have sold or given up his or her share of IRC section 751 property for Non-section IRC section 751 property.

Remember: Unrealized receivables are always considered IRC section 751 property distributed, but inventory must meet the substantially appreciated test in IRC section 751(b)(3) in order for it to be considered IRC section 751 property for disproportionate distributions.

Partner receives **more than** his or her pro rata share of IRC section 751 property

The partner is "deemed" to have sold or given up his or her share of Non-IRC section 751 property which includes cash and other property. The following occurs:

♦ **Partner Consequences –**

- The distributee partner recognizes gain or loss determined by the difference between the adjusted basis in the other property, Non-IRC section 751 property, given up/sold in the deemed exchange, for the FMV of the excess IRC section 751 property deemed to be received/purchased.

- The distributee partner's adjusted basis in the Non-IRC section 751 property given up/sold is the basis that the property would have had in a

current distribution under the regular distribution rules under IRC sections 731 through 735.

- The character of the gain or loss by the distributee partner is determined by the Non-IRC section 751 property given up. This will generally result in a taxable capital gain or loss to the distributee partner.

♦ **Partnership Consequences –**

- The partnership recognizes a gain or loss determined by the difference between the partnership's adjusted basis in the IRC section 751 property given up/sold in the deemed exchange and the FMV of the Non-IRC section 751 property that is deemed to be received/purchased.

- The FMV of the Non-IRC section 751 property deemed to be received/purchased is the distributee partner's FMV interest in the IRC section 751 property given up.

- The character of the gain or loss by the partnership is determined by the IRC section 751 property given up. It would always be ordinary income. The ordinary income that the partnership recognizes is reported as a separately stated item of income to all partners, other than the distributee partner, under IRC section 702(a)(7).

<u>Partner receives **less than** his or her pro rata share of IRC section 751 property</u>

The partner is "deemed" to have sold or given up his or her share of IRC section 751 property which includes unrealized receivables, depreciation recapture, and inventory. The following occurs:

♦ **Partner Consequences –**

- The distributee partner recognizes gain or loss determined by the difference between the adjusted basis in the IRC section 751 property, given up/sold in the deemed exchange, for the FMV of the Non-IRC section 751 property deemed to be received/purchased.

- The distributee partner's adjusted basis in IRC section 751 property given up/sold is the basis that the property would have had in a current distribution under the regular distribution rules under IRC section 731 through 735.

- The fair market value of the Non-IRC section 751 property received/purchased is the distributee partner's FMV interest in the IRC section 751 property given up/sold.

- The character of the gain or loss by the distributee partner is determined by the IRC section 751 property given up. This will always result in taxable ordinary income to the distributee partner.

♦ **Partnership Consequences –**

- The partnership recognizes a gain or loss determined by the difference between the partnership's adjusted basis in the Non-IRC section 751 property given up/sold in the deemed exchange and the FMV of the IRC section 751 property that is deemed to be received/purchased.

- The FMV of the IRC section 751 property deemed to be received/purchased is the distributee partner's FMV interest in the Non-IRC section 751 property given up.

- The character of the gain or loss by the partnership is determined by the Non-IRC section 751 property given up. It would generally be capital gain. The capital gain that the partnership recognizes is reported as a separately stated item of gain to all partners, other than the distributee partner, under IRC section 702(a)(7).

The mechanics of the disproportionate distribution can be broken down into a seven-step process. The following example will illustrate this process.

Example 4-20

X has a one-third interest in the capital, profits, and losses of the XYZ Partnership. X liquidates his entire interest in the partnership. XYZ distributes $25,000 cash. The partnership balance sheet appears as follows:

	Basis per XYZ Books	Fair Market Value
Cash	$25,000	$25,000
Inventory	15,000	25,000
Land	8,000	25,000
TOTAL	$48,000	$75,000
	Capital Accounts	
Partner X	$16,000	$25,000
Partner Y	16,000	25,000
Partner Z	16,000	25,000
TOTAL	$48,000	$75,000

Step 1: Divide assets on the balance sheet into 2 classifications

IRC section 751		
Property	$15,000	$25,000
Non IRC section 751		
Property:		
Land	8,000	25,000
Cash	25,000	25,000
TOTAL	$48,000	$75,000

Step 2: Determine the actual presence of IRC section 751 property.

Are there unrealized receivables? No

Is the inventory substantially appreciated in value? Yes

The inventory's FMV of $25,000 is 120 percent of the adjusted basis of all IRC section 751(d) items. Generally, these items include the following:

1) Inventory – Stock-in-trade
2) Unrealized Receivables
3) Accounts Receivable
4) Notes Receivable
5) Depreciation recapture

Step 3 Determine the property received by the distributee partner.

Note: The partnership agreement may specify what was exchanged for the IRC section 751 property and what falls under the regular distribution rules (IRC section 731 through 735). If the partnership agreement does not specify, then assume a proportionate share.

X received $25,000 cash in his liquidation of the partnership interest.

Step 4: Determine the "deemed" distribution.

A. Determine the FMV of the IRC section 751 property actually received by the distributee partner.

   Answer: $0

B. Determine the partner's proportionate share of the IRC section 751 property or the proportionate share of the Non IRC section 751 property at FMV.

   Answer: Proportionate share of IRC section 751 Property is $8,333.

C. Compare the IRC section 751 property actually received with the partner's proportionate share of the IRC section 751 property and determine the deemed distribution amount.

   Result: Negative Amount - (8,333)

Deemed Distribution Amount:

FMV of IRC section 751 property actually received		$0
- Proportionate share of the IRC section 751 assets		8,333
3 possible answers:	Zero	(8,333)
	Positive Amount	
	Negative Amount	

Zero IRC section 751 Amount:

STOP! The distributee partner has received his *proportionate* share of the IRC section 751 property – Regular distribution rules apply. IRC section 731 through IRC section 735

Positive IRC section 751 Amount:

The distributee partner has received **more than** his share of IRC section 751 property

1. To the extent of the positive IRC section 751 amount the partner is considered to have sold (given up) his interest in Non-IRC section 751 partnership property for IRC section 751 property.

Amount Realized = FMV of IRC section 751 Property
Adjusted Basis = Non IRC section 751 Property Given up

2. Distributee partner recognizes a capital gain or loss or an IRC section 1231 gain or loss on the sale of Non IRC section 751 property given up.

3. Partnership has opposite effect because it considers the IRC section 751 property sold (given up) to the distributee partner for Non-IRC section 751 property so ordinary income or loss results.

4. Refer to Treas. Reg. 1.751-1(b)(2)

Negative IRC section 751 Amount:

The distributee partner has received less than his share of the IRC section 751 property.

1. To the extent of the negative IRC section 751 amount, the distributee partner is considered to have sold (given up) his interest in IRC section 751 property to Non IRC section 751 property.

Amount Realized = FMV of Non IRC section 751 Property
Adjusted basis = IRC section 751 Property Given up

2. Distributee partner recognizes ordinary income or loss on the sale of the IRC section 751 property given up.

3. Partnership has the opposite effect because it is considered to have sold (given up) Non-IRC section 751 property for the IRC section 751 property so capital gain or loss results.

4. Refer to Treas. Reg. section 1.751-1(b)(3).

Step 5: Determine which property or properties are the deemed Asset given up.

X received cash which is a Non IRC section 751 property and in return he gave up inventory which is an IRC section 751 asset.

Step 6: Determine the tax consequences to the distributee partner

Deemed Exchange – Sale and Exchange Portion

Negative Amount	$8,333
Less: Adjusted Basis in Proportionate share of Deemed Distribution (Adjusted basis in IRC section 751 property given up)	
Inventory	5,000
Gain – Ordinary IRC section 1001(c)	**$3,333**

Note: The character of the gain depends on the property given up.

Regular Distribution Portion

Adjusted basis in the Partnership interest Before Distribution	$16,000
Less: Adjusted basis in Deemed distribution IRC section 751 property same as sale and exchange)	5,000
Remaining basis in Partnership interest After deemed distribution	11,000
Less: Money and Debt Relief after Deemed Exchange takes place ($25,000 less $8,333)	16,667
IRC section 731(a) Gain -	$ 5,667

Step 7: Tax consequences to the Partnership

Negative Amount	$8,333
Less: Adjusted Basis In Non IRC section 751 property Given up (Cash – 25,000 x 1/3)	8,333
Gain/Capital or IRC section 1231	$ 0

Note: No gain is recognized by the partnership if the partnership uses cash or debt relief to purchase interest in IRC section 751 property because the adjusted basis and FMV of this type of Non IRC section 751 property is the same.

If the partnership had a IRC section 754 election in effect, the partnership would be entitled to increase its basis in its land by $5,667 which is the amount of regular distribution IRC section 731(a) gain recognized by the partner.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

Are there distributions reported on the Schedules K-1? The Schedule M-2 should also reflect any distributions. This will alert you that there has been either a current or liquidating distribution. Does the Schedule K-1 reflect a cash distribution? If so then, cash received in excess of the partner's basis in his partnership interest is taxable under IRC section 731(a).

What type of property has been distributed? The changes in the assets and liabilities on the balance sheet should help in this identification. If there was a disproportionate amount of IRC section 751 property distributed in the transaction, there may be a gain that must be recognized. This is true if there is a partial liquidation or a complete liquidation.

Has there been a change in ownership on the Schedules K-1? If there has then there is a potential partial liquidation or complete liquidation.

Does it appear that a disproportionate amount of IRC section 751 assets were distributed in a partial or complete liquidation? Were all IRC section 751 assets taken into account? This will impact the recognition of ordinary income or capital gain to the partner or the partnership.

Was there an IRC section 754 and IRC section 734(b) election in effect? Make sure that the basis was stepped up or down to the appropriate assets remaining in the partnership.

Issue Identification

Issue Identification for Proportionate Current and Liquidating Distributions are similar. Refer to the section above.

Documents to Request

Documents requested are similar to Proportionate Current and Liquidating Distribution. Refer to the section above.

Interview Questions

What type of assets were distributed in the distribution and to which partners?

Did the distributions cause a liquidation? Were there a series of distributions made? If there were, then have all of them been made because there is not a complete liquidation until this has happened.

Was this a retirement of a partner? If it was, refer to Chapter 7.

Was there an IRC section 754 and an IRC section 734(b) election in which the basis in the remaining assets was adjusted. Request the calculation.

Was there any cash, marketable securities, or debt relief distributed? If so, then request a basis calculation of the distributee partner to make sure there was not money received in excess of the partner's outside basis.

Supporting Law

IRC, Subchapter K: section 731
section 732
section 734
section 751
section 752
section 754

Supporting regulations and specific regulations cited above.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

McKee, William S., Nelson, William F., and Whitmire, Robert L. Federal Taxation of Partnership and Partners, Boston MA: Warren Gorham & Lamont, publisher.

Cunningham, Laura E., Cunningham Noel B., The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnership

Chapter 5

Loss Limitations

INTRODUCTION

A partner must meet several loss limitation requirements, before a loss is allowed. The loss limitation tiers must be met in the following order:

1. Does the partner have adequate basis in its partnership interest to deduct losses?

2. Does the partner have adequate amounts at-risk in its partnership to deduct losses?

3. Is the partnership activity a rental real estate activity or an equipment leasing activity? If so, partner losses are presumptively passive, that is, nondeductible in the absence of passive income. (But see IRC section 469(c)(7))

4. If the partnership activity is a trade or business, does the partner materially participate under the passive activity rules?

If a partner does not meet any one of the loss limitation tiers, the losses are suspended at that level. They will remain at that tier until the losses can meet the requirements. The losses will then be carried forward to the next level in the same manner until the losses will eventually be allowed.

There are exceptions to general loss limitation rules relating to transactions between a partnership and its partners under IRC section 707(b).

ISSUE: BASIS LIMITATIONS

The first tier that must be considered is the basis limitation. This test must be met before at-risk and passive limitations apply. The partner must have sufficient outside basis at the end of the partnership tax year in its partnership interest to deduct losses. The partner's outside basis is not allowed to fall below zero. IRC section 705(a)(2) and IRC section 733. Therefore, if current year losses for the year exceed the partner's outside basis, the losses will be suspended. These losses will be carried forward to subsequent years until the partner's basis is increased to allow the losses. If the partnership interest is sold, any unused losses disappear and cannot be used to offset any gain on the disposition. IRC section 704(d).

There are two basic ways to increase basis:

1. Cash and the adjusted basis of property contributed (including the partner's share of partnership liabilities)

2. Partner's share of partnership income (taxable and tax exempt)

There are two basic ways to decrease basis, but not below zero:

1. Distributions from the partnership of cash and the adjusted basis of property distributed (including the partner's decreased share of partnership liabilities)

2. Partner's share of partnership losses (whether or not deductible for taxes)

The outside basis determines how much of the basis may be reduced by distributions before recognizing a gain. If the partner is distributed cash in excess of its basis, there will be a gain recognized.

The outside basis also determines how much of the basis may be reduced by losses flowing from the partnership. If there are more losses flowing through the partnership to the partner than there is basis in the partner's interest, then instead of a gain recognized, the losses exceed the outside basis are suspended until the partner has basis to claim these losses in a subsequent year. ***Kingbay v. Commissioner***, 46 T.C. 147.

Distributions reduce basis first and the partner's allocable share of ordinary losses are considered second. Revenue Ruling 66-94, 1966-1 C.B. 166. The ordering of these rules is important because the distributions are recovered through basis first so there potentially will be no gain recognized. Then losses are considered. If the losses would make the basis fall below zero they are suspended, but are not lost forever. See Chapter III for basis ordering rules.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Do the partner's current year cash distributions exceed the partner's outside basis? If so, then the taxpayer must report a gain for the excess distribution. (Remember debt relief is considered a deemed cash distribution.)

- Did the partner receive a property distribution? If so, did the property's adjusted basis in the partnership's hands reduce the partner's basis? Was the property's adjusted basis more than the adjusted basis in the partnership interest? If it was, then the basis in the partnership is now zero. No losses will be allowed. They will be suspended.

- Does the partner have sufficient basis to deduct the partner's share of partnership losses? If not, then the losses must be suspended indefinitely until the basis is increased.

Issue Identification

Request the partner's outside basis calculation, if losses are present on the partnership return.

Request the partner's related returns to review losses actually taken on the returns.

Review the partnership return to see if there were negative capital accounts at the end of last year and current losses on this return. If so, there may be a possibility that several of the partners' outside bases are zero. This may be of greater concern if this is the final year of the partnership.

Review the suspended loss computation for accuracy.

Review any cash or property distributions to any of the partners.

Documents to Request

1. Prior and subsequent year returns
2. Outside basis computation
3. Suspended loss computation
4. Partnership books and records
5. Partnership agreement

Interview Questions

1. Were there any cash or property distributions to any of the partners during the year?

2. How many years has the partnership operated with losses?

Supporting Law

IRC, Subchapter K: Section 704

Section 705
Section 733

Supporting regulation and specific regulations cited above.

Kingbay v. Commissioner 46 T.C. 147 – Deductions of partnership loss by limited partners is allowed only to the extent of the adjusted bases of their interests in the partnership at the end of the partnership year in which a loss occurred. Their adjusted basis in the current year was determined to be zero because of reduction by partners' distributive share of the partnership losses.

Revenue Ruling 66-94, 1966-1 C.B. 166 – This ruling determines that distributions are taken into consideration before losses in computing a partner's adjusted basis in the partnership interest under IRC section 704(a).

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Practitioners Publishing Co.

ISSUE: AT-RISK LIMITATIONS

The second tier that must be considered is the at-risk limitations. At-risk rules are covered under IRC section 465 and are not part of Subchapter K. These rules apply to individuals and closely held corporations. It reflects the amount a partner is at-risk in the partnership activity. It is essentially the amount of cash that a partner would be out-of-pocket for if the partnership ceased business. The at-risk limitations operate somewhat in the same way as basis limitations. The at-risk amount cannot fall below zero. If there are losses in excess of the amount that a partner is at-risk, then these losses are suspended and carried forward until such time the partner increases his or her amount at-risk. These suspended losses can be carried forward indefinitely. Contrary to the basis rules under IRC section 704(d), suspended losses may be used to offset any gain on the sale of a partnership interest. Prop. Treas. Reg. section 1.465-66. If withdrawals, distributions, or loan repayments are made that reduce the amount of at-risk below zero, the partner usually recognizes income. At-risk is computed at year end.

Originally when the at-risk rules were enacted in 1976, the activities they applied to were:

1) Farming
2) Exploring for or exploiting oil and gas resources
3) Holding, producing, or distributing motion picture films or videotapes
4) Equipment leasing
5) Exploring for or exploiting geothermal deposits.

These activities were originally chosen because Congress thought most tax shelters would fall within these categories. At-risk rules were created to deter the creation of tax shelters. The law has been broadened to include all activities. The at-risk rules are usually applied on an activity-by-activity basis; however, they can be aggregated together.

Do not confuse the at-risk aggregation rules with the aggregation rules for passive activities. They are different. The original five activities are all to be considered

separate activities except for equipment leasing. Any other activity including equipment leasing can be grouped together to apply the at-risk rules, if either of the following requirements can be met:

1. Taxpayer actively participates in the management of the trade or business, or

2. Trade or business is carried on by a partnership or S Corporation and 65 percent or more of the losses for the tax year are allocable to persons who actively participate in the management of the trade or business.

When activities are aggregated together, it is more likely that the amounts at-risk will not fall below zero. For example, all contributions or recourse loans are accounted for as one activity whether they were specifically for a particular activity or not.

At-Risk Computation

+ Cash invested
+ Loans which are recourse to general partners
+ Loans in which a partner is personally liable for repayment, such as a guarantee on a non-recourse debt with no reimbursements, or the partner must have pledged his or her own property (other than the property used in the activity) as security for the repayment (only to extent of the net FMV in the partner's interest in the pledged property). This applies to limited and general partners. ***Callahan v. Commissioner***, 98 T.C. 276 (1992)

+ Direct loans by partners except if the activity is one of the original five activities. (See discussion below)
+ A/B of any property contributed to the partnership
+ Partner's share of income (taxable and tax exempt) and gain on a disposition of a partnership interest
+ Qualified Non-recourse Debt – Real Property
- Repayments on loans for which a partner is at-risk
- Distributions to a partner of cash or adjusted basis of other property
- Partner's share of losses and capital losses
= At-risk for the partner

Under normal circumstances all non-recourse loans are omitted from the computation because partners are not considered at-risk for these type of loans. They do not bear any risk of loss. They will have no cash-out-of pocket if the loan defaults. The creditor is the one at-risk. Qualified non-recourse financing is an exception to this rule. IRC section 465(b)(6) and Treas. Reg. sections 1.465-27(a).

Qualified non-recourse financing is debt that is secured by real property and other property that is incidental to holding the real property. It must meet the following requirements to be included in the amount at-risk.

1. Funds are loaned for the real property
2. Funds are loaned from a "qualified person," or a federal, state, or local government entity
3. No person is personally liable on the loan (If it is a real estate partnership, the partnership may be liable on the debt and not cause this requirement to fail). Treas. Reg. section 1.465-27(b)(3)
4. Loan is not convertible to a partnership interest. Be aware that this feature automatically taints the loan as not being a qualified non-recourse loan. Make sure that the third party lender does not have an option agreement to convert the loan into an equity interest in the partnership at a later date.

A "**qualified person**" for these purposes is any person who is actively and regularly engaged in the business of making loans such as a commercial lending institution. In most circumstances it cannot be a related person, a person that is the seller or related to the seller of the real property, or a person who receives a fee with respect to the investment in the property such as a real estate broker or a related person. A "qualified person" may be a related party if they meet the following requirements:

1. Related person is actively and regularly engaged in the business of making loans

2. Loan is commercially reasonable which means:
   a. Note is written, unconditional promise to pay a sum certain on demand on a specific date
   b. Interest rate on the note cannot be above or below market rate and cannot be contingent on profits

3. Loan must be substantially the same terms as an arms-length loan between unrelated parties.

Related party loans are not included in the amounts at-risk such as family members or controlled corporations who have an interest in the activity. IRC section 465(b)(3)(A). Remember that when applying IRC section 267(b) and IRC section 707(b)(1) that for the at-risk rule 50 percent should be replaced with 10 percent. IRC section 465(b)(3)(C).

Losses can be used partially in the current year and then the remainder will be suspended and carried forward. Taxpayers must follow an ordering rule to deduct the losses in the current year. Proposed Treas. Reg. sections 1.465-38.

1. Capital losses
2. IRC section 1231 losses
3. All other losses and deductions except Tax preference items under IRC section 57
4. Tax Preference items under IRC section 57

The losses retain their character when carried over in the subsequent year and will follow this same ordering rule.

Taxpayers who have losses from at-risk activities must file a Form 6198.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Does the partner have sufficient amount at-risk to allow losses? Review the at-risk computation.
- Does the partnership have non-recourse debt that is potentially being included in the partner's at-risk amount?
- Does the partner have any relief of debt that may result in the at-risk amount falling below zero?
- Does the partner aggregate activities to allow recourse debt from another activity to increase at-risk in all other activities? Are the management requirements met?
- Does the partnership have qualified non-recourse financing? Does the financing meet all of the requirements?
- Are there any related party loans? These will probably not be included in the at-risk computation.
- Are there suspended losses from prior years? Is the character of these losses being carried forward intact?

Issue Identification

If it appears there is potential non-recourse debt included in the amount at-risk, then request the at-risk computation to determine if the partners have sufficient at-risk amounts.

Request the debt instruments to determine what type of loans are on the books and on the tax return. If it is qualified non-recourse debt, make sure that the requirements have been met to be qualified? Determine if there are any related party loans.

Request a list of the groupings of the activities that have been aggregated. Also, request what trade or business is carried on within the activities. Does the partner meet the management requirements?

Request a list of the suspended losses and their character?

Request the recourse loan documents to review for any changes in the economic at-risk of loss with the partners in the last 3 years. If any partner is relieved of recourse liabilities, then this will reduce the amount at-risk. The partner may have already taken losses against this recourse debt. If the relief of debt results in the at-risk amount falling below zero, then income will be recognized for recapture of this amount.

Documents to Request

1. Prior and Subsequent year partnership tax returns
2. Debt Instruments
3. At-risk computation
4. Aggregation of activities
5. Trade or businesses involved with the aggregated activities
6. Duties of the partners within the aggregated activities
7. Related party loans
8. Suspended loss computation

Interview Questions

1. What type of loans are represented on the tax return?

2. Are any of the loans recourse and qualified non-recourse loans?

3. Has there been a change in the debt instruments in the last 3 years?

4. Did the partner aggregate the activities? What management duties do the partners have?

5. Do the partners have at-risk computations available?

6. Are there any related party loans?

7. Are there any suspended losses from prior years?

Supporting Law

IRC, Subchapter K: Section 707
IRC section 465
IRC section 267
Supporting regulation and specific regulations cited above.

Callahan v. Commissioner, 98 T.C. 276 (1992) – The limited partners were required if called upon by the general partners to pay three times the amount of cash contributions. The limited partners had the discretion, by written notice, to elect out of the overcall provisions. It was determined that the limited partners were not at-risk for this amount because the partners' obligations were contingent and illusory.

Resources

RIA U.S. Tax Reporter – Income Tax

CCH Standard Federal Tax Reporter

Tax Management Portfolio

Practitioners Publishing Co.

ISSUE: LIMITATIONS ON RELATED PARTNER AND NON-PARTNER TRANSACTIONS

Related Partners

IRC section 707(a) states that certain transactions between partners and partnerships are treated as if between the partnership and non-partners.

IRC section 707(b) limits the general rule set forth in IRC section 707(a) in two ways:

Loss Disallowance

- IRC section 707(b)(1)(A) states that no losses will be recognized on a sale or exchange of property between a partner and the partnership if the partner owns greater than 50 percent of the capital or profits in the partnership either directly or indirectly.

- IRC section 707(b)(1)(B) states that no losses will be recognized on a sale or exchange of property between two partnerships if the same persons own greater than 50 percent of the capital or profits of both partnerships either directly or indirectly.

For example, if property is sold by a greater than 50 percent partner to the partnership, there would be a realized, but not recognized, loss by the partner. If the partnership later disposes of the property at a gain, the unrecognized loss will offset the partnership gain on the asset. However, without a special IRC section 704(b) allocation, all partners will partake in the benefit of the unrecognized loss offset.

Capital Gain Disallowance

- IRC section 707(b)(2)(A) states that any gain is ordinary income, if property which is not a capital asset in the transferee's hands, is sold at a gain between a partnership and a partner who owns greater than 50 percent of the capital and profits of the partnership either directly or indirectly.

- IRC section 707(b)(2)(B) states that any gain is ordinary income, if property which is not a capital asset in the transferee's hands, is sold at a gain between two partnerships in which greater than 50 percent of the capital or profits is owned by the same persons directly or indirectly.

Constructive ownership rules are determined by applying IRC section 267(c) IRC section 707(b)(3) and Treas. Reg. section 1.707-1(b)(3).

Related Non-partners

Losses on sales between related non-partners are not governed by IRC section 707(b). IRC section 267 rules relating to loss on sales between related taxpayers applies to these transactions. If any one of the relationships exist under IRC section 267(b), losses are disallowed between the partnership and the other person who is not a partner. This is true even if the non-partner is a spouse of a partner and regardless of the percentage of capital or profits interest that the partner may own.

For example, if a partner owns 5 percent of the capital and profits of a partnership and the partnership sold property to the partner's spouse at a loss, that partner's 5 percent share of the partnership loss would be disallowed. If, on the other hand, the partnership had sold property to the 5 percent partner, the loss would be allowed because the partner is less than 50 percent partner under Treas. Reg. section 1.267(b)-1(b)(1)(ii).

If this same 5 percent partner's spouse sold property to the partnership for a loss, the entire loss would be disallowed under Treas. Reg. section 1.267(b)-1(b)(1)(ii).

Gains on sales between non-partners and partnerships are not governed by IRC section 707(b) or IRC section 1239. Therefore, gain on a sale of depreciable property by the 5 percent partner's spouse will result in capital gain instead of ordinary income.

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Are there any sale or exchange transactions between the partnership and any greater than 50 percent partners. If there are any that result in a recognized loss, then the loss should be disallowed.

- Are there any sale or exchange transactions between the partnership and any related party to a partner? If there are any that result in a recognized loss, then the loss should be disallowed.

- Are there any sale or exchange transactions between the partnership and the partners that result in a gain? If there are any that result in a recognized capital gain, then review the transaction to see if the asset in the transferee hands was a capital asset. If it was not, then the capital gain should be recharacterized to ordinary income.

Issue Identification

Review the partnership agreement to determine which partners own greater than 50 percent of the capital or profits of the partnership.

Request all documents for any exchanges between the partnership and the partners. Review for losses on the exchange if the partner owns greater than 50 percent of the capital or profits. Review for potential capital gain treatment by a greater than 50 percent partner.

Request all documents for any exchanges between the partnership and a related party of any of the partners. Review for losses on the exchange. Losses are disallowed.

Documents to Request

1. Partnership agreement
2. Prior and subsequent year partnership returns
3. Related party tax returns
4. Exchange documents between the partnership and the partners and related parties.
5. Asset documentation for prior characterization of the asset exchanged.

Interview Questions

1. Were there any sale and exchange transactions during the year between the partnership and any partner?

2. Were there any sale and exchange transactions during the year between the partnership and a related party of any partner?

Supporting Law

IRC, Subchapter K: Section 707

IRC section 267

IRC section 1239
Supporting regulation and specific regulations cited above.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, and Robert L. Whitmire, Warren, Gorham & Lamont

ISSUE: AUTOMATIC ADJUSTMENTS DUE TO PASSIVE LOSS LIMITATIONS

When processing flow through items, *any* adjustment which increases the partner's modified AGI over $100,000 could result in an automatic adjustment, if not outright disallowance, of the partner's rental real estate losses. Under IRC section 469(i), a $25,000 offset for rental real estate losses is permitted if the taxpayer actively participates in the activity. However, the $25,000 offset is phased out at the rate of 50 cents for every dollar modified AGI exceeds $100,000. When the partner's modified AGI is greater than $150,000 no rental loss is permitted (unless the taxpayer has passive income, which is relatively rare). Modified AGI is simply AGI computed without any passive loss or passive income (plus several minor modifiers which are not commonly seen). For more information, see the Passive Activity Loss Guide, Chapter 2.

Examination Techniques

The examination techniques should serve, in the end, to answer the following:

- Review each partner's return for adjustments which will push AGI over $150,000. If there is any loss on Schedule E line 24, there is a potential automatic adjustment.

- If AGI is over $150,000, in most cases, modified AGI is also greater than $150,000. In other words, there is generally no need to compute modified AGI. Furthermore, if the partner's modified AGI exceeds $150,000, there is no need to compute Form 8582. In the absence of passive income, rental losses are simply disallowed.

- For the report, simply make a statement to the following effect: Since the taxpayer's modified adjusted gross income as defined in IRC section 469(i) exceeds $150,000, no loss is allowable in the current year. Losses must be carried forward to the next year and entered on Form 8582 line 1c.

Issue Identification

If there is a Form 8582 attached to the return, check lines 1a and 2a to see if there is any remaining passive income (rare). In some cases, Form 8582 is not filed. However, passive income would be reflected on Schedule E line 22 or on the back of Schedule E in the passive income column.

Also verify that the taxpayer is not a real estate professional via review of Schedule E line 42. If there is an entry on line 42, the taxpayer may not be subject to the passive loss limitations. See discussion of the real estate professional rules below.

Documents to Request

1. Partners' Forms 1040.

Interview Questions

None. The adjustment is computational, similar to the medical adjustment.

Supporting Law

IRC section 469(i)(2) Up to $25,000 in rental real estate losses of an individual may be deducted if the individual actively participates in the activity.

IRC section 469(i)(3) The $25,000 offset is phased out at the rate of 50 cents for every dollar of modified AGI in excess of $100,000.

Resources

Passive Activity Losses, MSSP Audit Guide, Chapter 2

MSSP Bulletin Board, Passive Loss Library
Lucy H. Clark, Passive Activity Issue Specialist (National), 603-433-0723

Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, and Robert L. Whitmire, Warren, Gorham & Lamont

ISSUE: EQUIPMENT, AIRPLANE AND OTHER LEASES

Rentals are passive activities, regardless of the taxpayer's level of participation. Losses from a partnership which leases equipment, airplanes, computers, office furniture, vehicles and other personal property are generally not deductible by the partners – even if leased back to an entity where the partner works. It does not matter whether the partner materially participates or not. Equipment leasing losses are generally nondeductible in the absence of passive income. Thus, if an

airplane, for example, is leased all year long to an entity, no loss is deductible in the absence of passive income.

Short-term rentals (7 days or less) fall outside the definition of a rental activity and are treated like a business, subject to the material participation standard. However, if the lessee has a recurring right to use the property, then it is deemed a true rental. No standard applies for rentals of equipment. Losses are simply not deductible in the absence of passive income. They go on Form 8582 line 2b and are suspended until such time as the partner has passive income or an entire disposition.

Examination Techniques

The examination techniques should serve, in the end, to answer the following:

- Passive rental losses should be entered on Form 8582 line 2b. As a general rule, they should not be reflected on Schedule E in the non-passive column, which completely avoids the passive loss limitations. Many taxpayers and representatives are unaware that equipment leasing activities are subject to the passive loss limitations.

- If the partnership itself is a leasing activity, all partner losses have a passive taint.

- In some cases, partnerships which conduct a business segregate equipment, furniture and fixtures and/or vehicles into a separate entity. That property is then leased back to the partnership. As a general rule, losses from the entity leasing the property to the partnership are passive. Thus, the investors should be entering those losses on Form 8582 line 2b.

- Many taxpayers assume if they materially participate in the leasing activity, rental losses escape the passive taint. However, IRC section 469(c)(2) and (4) explicitly hold that rentals are passive, regardless of whether the taxpayer materially participates.

Issue Identification

Peruse Blocks A, B and C of Form 1065 for indicators that the partnership activity is leasing activity.

Review partners' Forms 1040 for equipment leasing losses erroneously entered on Schedule E in the non-passive column. Equipment leasing activities should not be in the non-passive column. They should be reflected on Form 8582 line 2b and are deductible in the passive column only if there is sufficient passive income against which to offset the losses.

Documents to Request

Lease covering the years under examination. If there is no lease, explain the terms of the oral agreements.

Interview Questions

1. Ask at the initial interview if the partnership itself is a leasing activity or if it leases property from another partnership or S corporation.

2. Explain how the leasing activity works and identify the customers.

3. Does the lessee have a recurring right to use the property?

4. Explain who the equipment is leased to and for what period(s) of time.

5. Explain what services, if any, the taxpayer provides with the equipment.

Supporting Law

IRC section 469(a) and (d) ─ Passive losses are deductible only to extent of passive income.

IRC section 469(c)(2) and (4) ─ A rental or leasing activity is passive regardless of whether the taxpayer materially participates.

IRC section 469(j)(8) and Treas. Reg. section 1.469-1T(e)(3)(i) ─ A rental is any activity where payments are principally for the use of tangible property.

Treas. Reg. section 1.469-1T(e)(3)(ii)(A) ─ Activity falls outside rental definition if average customer use is 7 days or less. If the average customer use is 7 days or less, it is treated like a business, subject to material participation (IRC section 469(h) and Treas. Reg. section 1.469-5T(a)).

Treas. Reg. section 1.469-1(e)(3)(iii) Final Reg. ─ Each period during which a customer has a recurring right to use the property is a separate period. For example if the property is used only a few hours at a time, but the lessee has a recurring right to use the property all year, the period of customer use is a year. It will be treated as a rental activity (passive regardless of participation), not a business, subject to material participation. *Review the lease.*

Treas. Reg. section 1.469-1T(e)(3)(ii)(C) ─ Activity falls outside the rental definition and is treated like a business ***if*** taxpayer provides extraordinary personal services, that is, the rental is incidental to services provided.

Treas. Reg. section 1.469-1T(e)(3)(ii)(F) ─ Property falls outside rental definition if provided for use in a partnership, S corporation or joint venture. Note that there is no exception for property provided to a C corporation. Also note that Treas. Reg. section 1.469-1T(e)(3)(vii) indicates that providing means contributing the property to a partnership or S corporation.

Treas. Reg. section 1.469-4(d)(1)(i) ─ General rule: rentals may not be grouped with businesses.

Treas. Reg. section 1.469-4(d)(1)(i)(A) and(C) Exception: rental can be grouped with business *if* insubstantial **or** owned in exact same percentage as business.

Treas. Reg. section 1.469-4(d)(5)(ii) ─ No grouping of a rental with a C corporation ever. Rentals can be grouped with a C corporation only to determine material or significant participation. Both standards apply to *businesses*, not to rentals. IRC section 469(c)(1)(B) and Treas. Reg. section 1.469-5T(c)(1)(i).

Resources

Passive Activity Losses, MSSP Audit Guide, Chapter 2

MSSP Bulletin Board, Passive Loss Library
Lucy H. Clark, Passive Activity Issue Specialist (National), 603-433-0723

Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, and Robert L. Whitmire, Warren, Gorham & Lamont

ISSUE: RENTAL REAL ESTATE LOSSES

Rental real estate is a passive activity – unless the partner is a real estate professional. Issues on real estate professionals are discussed in the next segment. For partners who are not real estate professionals, no rental losses may be deducted if the taxpayer's modified AGI exceeds $150,000. Furthermore, the $25,000 offset is not available to either limited partners or partners who own less than 10 percent of the partnership.

Examination Techniques

The examination techniques should serve, in the end, to answer the following:

- If the partnership conducts a rental real estate activity, scrutinize each partner's Form 1040 return for the following:

- Is there an entry in box 42 of Schedule E indicating he or she is a real estate professional? If so, losses will be deductible in the non-passive column, if he or she materially participates in the rental activity conducted by the

partnership. Material participation means he or she performed more than 500 hours during the year **or** did most of the work **or** met one of the other tests in Treas. Reg. section 1.469-5T. If the partner does not materially participate, losses remain passive (Treas. Reg. section 1.469-9(e) and should be entered on Form 8582 line 1b or 2b. Thus, they will be deductible only to the extent of passive income on Form 8582 line 10. See chapters 2 and 3 of the Passive Activity Losses Reference Guide (Training #3149-115, TPDS No. 83479V *Note: The guide will probably be revised shortly; thus, these numbers may change).*

- If the taxpayer is not a real estate professional (Schedule E line 42 is blank):

- Have partnership losses been entered in the non-passive column of Schedule E in error? Rental real estate is a passive activity under IRC section 469(c). Thus losses belong on Form 8582 line 1a, if the taxpayer actively participates, or line 2b, if not active. Form 8582 limits total rental losses to $25,000 and reduces the $25,000 special allowance to zero, when modified AGI exceeds $150,000.

  - Have limited partner's or those who own less than 10 percent of the partnership entered losses on Form 8582 line 1b, thereby giving himself the benefit of the $25,000 offset in error? Since a limited partner or anyone who owns less than 10 percent cannot be active, losses go on line 2b. Losses on Form 8582 line 2b are deductible only if there is passive income (which is relatively rare).

Issue Identification

Peruse Blocks A, B and C of Form 1065 for indicators that the partnership activity is rental real estate. Needless to say, if Form 8825 is attached to the 1065, you are probably dealing with rental real estate. If so, check Schedules K-1 for each partner to ascertain who is a limited partner or who owns less the 10 percent.

Documents to Request

1. Copies of each partner's Form 1040.

Interview Questions

1. If it is not clear from the return, ask if the partnership conducts a rental real estate activity?

2. Ask what the level of involvement is for each partner. Active participation is a liberal standard, requiring only management decisions in a bona fide sense. However, as stated above limited partners and those with less than 10 percent ownership interest cannot be active.

Supporting Law

IRC section 469(c)(2) ─ Rentals are passive activities.

IRC section 469(a) and (d) ─ Passive losses are deductible only to extent of passive income.

IRC section 469(c)(2) and (4) ─ A rental (or leasing) activity is passive regardless of whether the taxpayer materially participates. Exception: real estate professionals under IRC section 469(c)(7).

IRC section 469(c)(7) ─ Rental real estate of a qualifying real estate professional is excepted from the passive loss limitations if the taxpayer materially participates in the rental. The taxpayer must rise to all the following tests: (1) more than half his personal services must be in real property business and rental real estate; (2) he or she must spend more than 750 hours on real property businesses and real estate rentals during the year; and (3) he or she must materially participate in each separate real estate rental for losses to be fully deductible.

IRC section 469(i) ─ Exception for rental real estate up to $25,000 if MAGI less than $100,000. Note no exception for any other kind of rental.

IRC section 469(i)(3)(E) ─ Modified adjusted gross income (MAGI) for Form 8582 line 6 is determined by computing AGI without any passive loss (excess passive losses after netting with passive income), any rental losses (whether or not allowed by IRC section 469(c)(7)), IRA/SEP, taxable social security or one-half of self-employment tax.

IRC section 469(i)(6)(A) ─ The taxpayer is not active if his ownership interest is less than 10 percent. Losses go on F8582 line 2b (not line 1b); thus the taxpayer receives no $25,000 offset.

IRC section 469(i)(6)(C) ─ The taxpayer is not active if he is a limited partner. Losses go on F8582 line 2b (not line 1b); thus the taxpayer receives no $25,000 offset.

ISSUE: REAL ESTATE PROFESSIONALS

If a partner spends the majority of his or her time on real property businesses or rentals **and** more than 750 hours during the year, his or her rental real estate activities are no longer presumptively passive. Instead, they are treated like a business. If the taxpayer materially participates, losses are no longer subject to the passive loss rules. Many taxpayers incorrectly assume if they work in a real property business, rental losses are no longer subject to the passive loss limitations. The material participation requirement is ignored.

If the partner owns 50 percent or more of the partnership, each rental in a partnership is deemed a separate activity. Thus, the partner must rise to material participation (work more than 500 hours during the year, perform most of the work or meet one of the other tests in Treas. Reg. section 1.469-5T(a)) for each separate rental activity.

While few taxpayers do it, a timely election can be made to group rentals as a single activity, making it easier to rise to the material participation test. See Treas. Reg. section 1.469-9(g).

Examination Techniques

The examination techniques should serve, in the end, to answer the following:

- On review the partner's Form 1040, note whether he/she and his/her spouse have full-time jobs and other non-passive activities. Note where the rentals are located in proximity to the taxpayer's residence. Ask who performs most of the work on the rentals, husband or wife. Inquire what partner services the partner performs with his/her rentals.

- Because partnerships are not required to take passive losses or credits into account for their taxable year, the passive loss limitation is not a partnership item for TEFRA entities. There is no need to open the Form 1065, if it is already not open. The resolution of the issue of whether a partner is subject to the passive loss limitation is not a partnership item. Whether the passive loss limitations apply to a partner has no effect on any item on the partnership's books and records. For open TEFRA entities, the passive loss issue should be treated as an affected item.

Issue Identification

Scrutinize each rental property on Form 8825 and on Schedule E. The following are indictors that the partner does not materially participate:

- Commissions
- Management fees
- Large labor or wages
- Rental property is located a long distance from the partner's residence
- The taxpayer is a limited partner.

Documents to Request

1. Partner's Form 1040.

2. Copy of an election to group rentals as a single activity under Treas. Reg. section 1.469-9(g) and the return with which it was made. Most taxpayers

have not elected to group. Those that did, generally made the election with their 1995 Form 1040.

3. If the partnership grouped its rentals under the provisions of Treas. Reg. section 1.469-4(d)(5), a copy of the tax workpapers or any other documentation indicating rentals were grouped.

4. Services and hours performed by the taxpayer.

Interview Questions

1. Who monitors the rental? Who collects the rent? Who does the repairs?

2. Does the partnership pay anyone to manage the rental or handle rents, problems, etc.?

3. Do you have a real estate agent or manager? Ask for each rental property. Check Schedule E properties for large commissions or management fees. Also check for large labor expense - possibly a hired contractor spent more time than the taxpayer. If there is paid management, it is a strong indicator taxpayer did not materially participate.

4. Does a relative or friend manage/monitor the property for free?

5. Does a tenant receive free/reduced rent for managing the rentals – or for caring for the properties? This is common practice with large apartment buildings.

Supporting Law

IRC section 469(c)(7) ─ Rental real estate losses are *non*-passive if the taxpayer spends more than half his or her services and more than 750 hours on real property businesses and materially participates in his or her rentals.

IRC section 469(c)(7)(A)(ii) and Treas. Reg. section 1.469-9(e)(3) ─ Each rental is a separate activity unless taxpayer elected to group under Treas. Reg. section 1.469-9(g) (not seen often). Thus, even if taxpayer is a real estate professional, he or she still must meet material participation (Treas. Reg. section 1.469-5T(a)) for each separate rental before losses will be fully deductible.

Treas. Reg. section 1.469-9(e) ─ If taxpayer is a real estate professional, he or she still must materially participate in each separate rental before losses are non-passive. If the taxpayer does not materially participate, losses remain passive.

Treas. Reg. section 1.469-9(g) ─ The taxpayer must file a timely written election to group all rentals as a single activity.

Treas. Reg. section 1.469-9(h)(2) ─ Each rental in a partnership is a single interest in rental real estate if taxpayer owns 50 percent or more of the entity. The taxpayer may elect to treat all rental real estate interests as a single activity.

Treas. Reg. section 1.469-5T(a) ─ Tests to be applied to determine whether taxpayer materially participates, that is, whether losses are or are not deductible.

ISSUE: MATERIAL PARTICIPATION

In order to deduct losses from a partnership that conducts a business, the partner must prove that he or she works on a regular, continuous and substantial basis in the operations of the activity. There are seven tests for material participation in Treas. Reg. section 1.469-5T(a), the most common being the 500-hour test. See Chapter 3 of the Passive Activity Loss Guide.

The following hours are not counted in the hourly computations for material participation: investor-type activities (reading reports, monitoring as a non-manger, etc.) and work not customarily done by an owner if the purpose is to avoid the passive loss limitations. Treas. Reg. section 1.469-5T(f)(2).

Examination Techniques

The examination techniques should serve, in the end, to answer the following:

- At the initial interview, ask what services each partner performs for the partnership. Inquire how often each partner is at the partnership business location.

- Look for guaranteed payments or wages as an indicator that the partner does work on a regular basis in the partnership.

- When perusing the partners' Forms 1040, look for losses in the non-passive column. If losses are entered in the non-passive column, the taxpayer is indicating that he materially participates in the activity, that is, works on a regular, continuous and substantial basis in operations.

Issue Identification

The following items on a partner's Schedule K-1 are possible indicators that he or she does not materially participate in the partnership's business:

- Limited partnership interest
- Low ownership interest

- Partnership is a significant distance from the partner's residence

Documents to Request

1. From partners who do not appear to work regularly in the partnership, ask them to document services performed and hours attributable to those services for the year under examination.

2. Ask if the partnership activity has been grouped with a related business under the "activity" rules in Treas. Reg. section 1.469-4.

3. Request the partnership agreement with portions highlighted which address who manages the entity or any other item which may address the partners' participation.

Interview Questions

1. What services does the taxpayer perform and how many hours?

2. What records does taxpayer have to substantiate hours worked?

3. Is taxpayer directly involved in day-to-day management?

4. Is there an on-site manager/supervisor/foreman?

5. Does taxpayer have signatory authority on checks?

6. Does taxpayer have authority to borrow money? Hire/fire personnel?

7. Is work being performed by taxpayer required or necessary to the activity?

8. Is taxpayer compensated for participation? If not, why?

Supporting Law

IRC section 469(c)(1) ─ Passive activity is a business in which the taxpayer does not materially participate.

IRC section 469(h) ─ A taxpayer materially participates only if he is involved in the operations of an activity on a regular, continuous, and substantial basis.

Treas. Reg. section 1.469-5T(a) ─ Taxpayer materially participates if and only if he or she meets one of 7 tests. Most common: Does he or she work 500 hours in the activity in the year under exam?

Treas. Reg. section 1.469-5T(f)(4) ─ Reasonable means for proving hours requires (1) an identification of services provided and (2) hours spent performing those services during the year *based on* appointment books, calendars, narrative summaries.

ISSUE: SELF-RENTED PROPERTY

Passive losses are deductible only to the extent of passive income. Thus, it is important to scrutinize income on a partner's Form 8582 carefully. While the income is always reportable, if it is removed from Form 8582 as it does not constitute passive income, generally an adjustment to passive losses results.

It is common practice for many entities to hold their buildings (and sometimes equipment) in a partnership. The property is then leased back to a C corporation or S corporation in which the partner works (so-called self-rented property). If the partnership leasing the property produces net income, that income is non-passive. While rental income is generally passive, Treas. Reg. section 1.469-2(f)(6) recharacterizes the income as non-passive if the individual taxpayer materially participates in the entity leasing the property.

There is a grandfather provision in the law, which permits income in this scenario to be passive. If there is a written, currently binding lease, signed before Feb. 18, 1988, net rental income is passive. It is unlikely that a pre-1988 lease would bind the current year. Needless to say, the taxpayer would need to have a 15-year lease to invoke this exception.

Examination Techniques

The examination techniques should serve in the end, to answer the following:

- When examining a partnership with net income from rental real estate, ask who leases the building. Ask if any of the partners work in the entity leasing the property. Also, ask to see any leases.

Issue Identification

Review Form 8582 with each partner's return to see if Schedule K-1 income was incorrectly entered on line 1a (worksheet 1), thereby triggering unrelated passive losses in error. Since the income is non-passive, it should be entered only on the back of Schedule E in the non-passive income column.

Documents to Request

The lease for the year under examination.

Interview Questions

1. Are there any leases?

2. Do any of the partners work in the entity leasing the property?

Supporting Law

Treas. Reg. section 1.469-2(f)(6) ─ Rental income (but not losses) from property leased to an entity where the taxpayer works (that is, materially participates) is non-passive. In other words, it does not go on F8582 line 1a and cannot be used to trigger unrelated passive losses.

Treas. Reg. section 1.469-11(c)(ii) ─ Self-rented income is passive **if** there is a lease signed before February 19, 1988, which binds the current year.

Chapter 6

Partnership Allocations

INTRODUCTION

For partnership allocations to be respected, they must either be made in accordance with the partners' interests in the partnership or they must meet the requirements for the substantial economic effect safe harbor. If allocations do not have substantial economic effect, they will be reallocated according to the partners' interests in the partnership.

This chapter will describe:

- Factors considered in determining the partners' interests in the partnership
- Economic effect
- Substantiality
- Allocation of items attributable to non-recourse debt
- Allocation of tax credits

This chapter will summarize a complex system of rules which have been designed to curb abuse. IRC section 704(b) was intended to stop partners from allocating deductions based on purely tax rather than economic consequences. The rules governing partnership allocations (IRC section 704(b) and its accompanying regulations) has been criticized as being some of the most difficult and complex. Simple business enterprises, which allocate income and loss in a straightforward and consistent manner, should not be unduly concerned with the complexity of IRC section 704(b).

Unlike S corporations, which must report all income and expenses in proportion to stock ownership, partnerships provide the flexibility of making special allocations of income, gain, loss, or deductions among the various partners. For example, a partnership agreement may allocate all of the depreciation deductions to one partner subject to the limitations described below. Additionally, a partnership agreement may specify that the partners may share capital, profits, and losses in different ratios. Stated differently, the sharing of profits does not have to coincide with the sharing of losses.

Because of the flexibility inherent in Subchapter K, partnership agreements can be written to reflect whatever economic sharing arrangement and risk sharing arrangement the parties wish to execute. For example, Partner A who has skills goes

into business with Partner B who has capital. Partner B contributes $100,000 in cash. A and B agree to split the business profits 20/80 until B recovers his entire investment; thereafter profits are split 50/50. Special allocations permit partners to assume different levels of risk and to set the timing of income in accordance with their preferences.

Such flexibility comes with strings attached. Partners are not able to allocate tax benefits among themselves in a manner that is divorced from their allocation of economic profit or loss. A partner who is economically enriched by an item of partnership income or gain is required to shoulder the associated tax burden. Similarly, a partner who is economically hurt by an item of partnership loss will be allocated the tax benefit of the loss. The tax allocations must ultimately conform to the economics of the partnership's transactions.

Even if the tax allocations of income, gain, loss, or deductions clearly reflect the economic sharing arrangement of the partners, other statutory provisions may come into play:

1. IRC section 704(c) prescribes rules for sharing allocations pertaining to contributed property.
2. IRC section 704(d) prevents a partner from deducting loss if it exceeds the basis of his partnership interest.
3. IRC section 465 limits deduction of distributive share of partnership loss to amounts at-risk.
4. IRC section 469 limits deduction of distributive share of partnership loss from passive activities

ISSUE: TESTING PARTNERSHIP ALLOCATIONS

An allocation of partnership income, gain, loss, deduction, or credit will be respected if it meets any one of the following tests:

1. is made in accordance with the partners' interests in the partnership, or
2. has substantial economic effect, or
3. is considered to be made in accordance with the partners' interest in the partnership under the special rules of Treas. Reg. section 1.704-1(b)(4).

The last category covers allocations of tax credits, percentage depletion in excess of cost, and deductions or losses attributable to partnership non-recourse liabilities.

The following sections will cover these **three tests** by which partnership allocations will be respected.

Partner's Interest in the Partnership Test

Partnership Agreement

A partner's distributive share of income, gain, loss, deduction, or credit is generally determined by the partnership agreement. The term "partnership agreement" is very broad and refers to any agreement which has an impact on the economic sharing arrangement among the partners or between one or more partners and the partnership Treas. Reg. section 1.704-1(b)(2)(ii)(h). The partnership agreement may be oral or written. 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 may be:

- Loan and credit agreements
- Assumption agreements
- Indemnification agreements
- Subordination agreements
- Correspondence with a lender concerning terms of a loan
- Guarantees

Emphasis: The partnership agreement encompasses more than just the partnership agreement document.

Determining the Partner's Interest in the Partnership

The partner's interest in the partnership test is a subjective facts and circumstances test. It seeks to determine the true economic sharing arrangement of the partners based on all of the facts and circumstances (Treas. Reg. section 1.704-1(b)(3)). The regulations consider the following factors to be relevant but not exclusive:

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 non-liquidating distributions
d) the rights of the partners to distributions of capital upon liquidation

There is an important interconnection between the partners' interest in the partnership test and the substantial economic effect test. The two tests can be viewed as two different roads leading to the same destination. Both seek to ensure that tax allocations parallel the partners' **economic sharing arrangement**. Allocations will be respected under either set of rules. The economic effect test is a

mechanical test governed by lengthy and detailed regulations. In contrast, the regulations covering the partners' interests in the partnership test are short, simple, and subjective.

The essence of both tests is to tie the tax allocations to the partners' economic sharing arrangement.

Substantial Economic Effect Test

The substantial economic effect test is actually a two-part test. An allocation is respected only if the allocation has "economic effect" and that economic effect is "substantial" Treas. Reg. section 1.704-1(b)(2)(ii).

Emphasis: "Economic effect" and "substantiality" are two separate and different inquiries. An allocation could have economic effect and still not be respected due to insubstantiality.

The economic effect test provides a "safe harbor". Its advantage is that it is mechanical and well defined. It removes the taxpayer from the subjectivity surrounding the partner's interest in the partnership test.

It is important to bear in mind that the economic effect test does not apply to non-recourse deductions or other tax allocations such as tax credits which do not have a corresponding economic allocation. The term "non-recourse deduction" refers to any loss, deduction, or IRC section 705(a)(2)(B) expenditure attributable to partnership non-recourse liabilities. A non-recourse liability is one in which the lender's only recourse is to the property securing the debt. Since the partners have no economic risk of loss with respect to the debt, deductions based on non-recourse deductions do not fall within the realm of substantial economic effect.

It is important to distinguish between recourse and non-recourse debt because the substantial economic effect test is only applicable in the context of recourse as opposed to non-recourse debt. The regulations contain a separate "safe harbor" for non-recourse deductions. This will be discussed in the section "Allocations Attributable to Non-recourse Deductions."

Emphasis: If the partnership is funding its losses or deduction through non-recourse debt, do not evaluate allocations based on substantial economic effect.

Economic Effect

The way the economic effect regulations tie tax allocations to economic benefits and burdens is through the capital accounts. For an allocation to satisfy the primary

economic effect test the partnership agreement must, throughout the full term of the partnership, provide as follows:

1. Capital Accounts: the partners must maintain their capital accounts in accordance with the rules contained in Treas. Reg. section 1.704-1(b)(2)(iv).

2. Liquidation: upon liquidation of the partnership, or any partner's interest in the partnership, liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners.

3. Unlimited Deficit Restoration: upon liquidation, a partner with a deficit in his capital account has an unconditional obligation to restore the amount of the deficit.

It should be emphasized that the first requirement focuses on the maintenance of book or economic capital accounts. The purpose of the capital account maintenance rules is to ensure that the underlying economic arrangement of the partners is clearly reflected. Analysis of the book capital accounts is intended to reveal the contribution obligations and the liquidation rights of the partners. If a partnership satisfies the primary economic effect test, then upon liquidation, a partner is entitled to any positive amount in his capital account balance or is obligated to restore a deficit capital account.

A partner is treated as obligated to restore the deficit balance in his capital account to the extent of any unconditional obligation of the partner to make subsequent contributions to the partnership by the partnership agreement or by state or local law.

Example 6-1

Hal, a high bracket taxpayer, and Larry, and a low bracket taxpayer form a general partnership in which they agree to allocate all of the depreciation deductions to Hal. Everything else is allocated equally. The partnership agreement contains the three requirements for the primary economic effect test. They each contribute $50,000 and obtain a recourse debt of $900,000. They purchase a building for $1,000,000. Their opening balance sheet is as follows:

Building	1,000,000	Recourse Debt	900,000
		Capital – Hal	50,000
		Capital – Larry	50,000
Assets	1,000,000	Liabilities & Capital	1,000,000

The partnership's income and expenses except for depreciation are equal. Only interest is paid on the debt. A $50,000 loss due to depreciation expense is allocated to Hal per the agreement. Thus, at the end of Year 1, Hal's capital account is reduced to zero. At the end of Year 2, Hal's capital account is a negative $50,000.

Scenario A:

The partnership sells the building for $1,100,000 and liquidates at the beginning of Year 3. Since the building's adjusted basis is $900,000, the gain is $200,000 ($1,100,000 less $900,000). Hal and Larry split the gain equally, each receiving $100,000:

	Capital – Hal	Capital – Larry
Beginning	(50,000)	50,000
Allocated Gain	100,000	100,000
Totals	50,000	150,000

Upon liquidation of the partnership, Hal and Larry would receive the amounts in their capital account balances, $50,000 to Hal and $150,000 to Larry. Hal has borne the economic burden of the depreciation deductions since his proceeds upon liquidation are reduced by that amount. Thus, the special allocation of all depreciation to Hal has economic effect.

Scenario B:

The partnership sells the building for $800,000 and liquidates at the beginning of Year 3. The sale produces a loss of $100,000 ($800,000 less adjusted basis of $900,000). The loss is split equally.

	Capital – Hal	Capital – Larry
Beginning	(50,000)	50,000
Allocated Loss	(50,000)	(50,000)
Totals	(100,000)	0

Because Hal is a general partner, under state law Hal is required to restore the negative amount in his capital account in order to pay the lender ($800,000 sales proceeds plus $100,00 from Hal). The allocation of depreciation to Hal has economic effect. Larry's liquidating distribution was based on his positive account balance and Hal was obligated to restore his capital account deficit.

Example 6-2

The facts are the same as in Example 6-1, but Hal is a limited partner, who is not obligated to restore any deficit in his capital account. Therefore, the partnership agreement fails to satisfy the third requirement of the primary economic effect test. Accordingly, the special allocation of depreciation to Hal would not have economic effect.

For purposes of IRC section 704(b), the partnership agreement includes all agreements among the partners or between the partners and the partnership. Thus, although the responsibility of the partnership's debt may appear to be shared equally among the partners, it is important to be alert to the impact of side agreements or guarantees.

Alternate Test for Economic Effect

The primary test for economic effect requires all of the partners to have an unconditional deficit restoration obligation. They must make contributions to restore negative capital accounts, if any, upon the partnership's liquidation. This requirement obviously presents a problem for limited partners who wish to limit their obligations to make additional capital contributions.

The alternate economic effect test addresses this situation. Under the alternate test, the first two requirements of the primary test for economic effect must be met (capital accounts must be maintained in accordance with the regulations and positive capital account balances must be respected upon the partnership's liquidation). However, an unlimited deficit restoration obligation is not required. Instead, the regulations require that the partnership agreement contain a "qualified income offset", sometimes called a "QIO provision."

The regulations state that the partnership agreement contains a qualified income offset if it provides that a partner who unexpectedly receives certain adjustments, allocations, or distributions will be allocated items of income and gain in order to eliminate a prohibited deficit balance as quickly as possible. If necessary, the partner will be allocated gross income or gain.

In summary, partners who are not required to restore negative capital account balances cannot be allocated items that would create a negative capital account beyond their obligation to restore. The QIO provision is intended to eliminate any unexpected deficit balance in a partner's capital accounts. The QIO provision is especially important in the context of partnership non-recourse debt, which will be discussed later in the chapter.

Economic Effect Equivalence

The economic effect equivalence test is also known as the "dumb-but-lucky" rule. Treas. Reg. section 1.704-1(b)(2)(ii). This provision can protect allocations based on unsophisticated but unabusive partnership agreements from falling outside the parameters of the economic effect safe harbor. If a partnership agreement fails to include the three requirements needed to satisfy the economic effect test, its allocations can, in many instances, still be respected. For this to happen, it has to be shown that a liquidation of a partnership at the end of the year in which the allocation in question takes place, would produce the same results that would occur if the three requirements of the primary economic effect test had been met.

Example 6-3

Joe, a real estate developer and Sara, a physician, form a partnership to operate an apartment building. Sara is a limited partner who contributes $100,000 to be used as working capital and guarantees $100,000 of the partnership's $500,000 debt. Joe is a general partner. Joe and Sara want to cut expenses, so they write their own partnership agreement without consulting an accountant or attorney. They agree that all of the losses will go to Sara, with future profits being split 50/50. They are unaware of the complex provisions of IRC section 704(b) so none of the requirements for meeting the primary economic effect test or the alternate economic effect test are included in their partnership agreement.

At the end of 5 years, the partnership has cumulative losses of $50,000 which have been allocated to Sara. The partnership liquidates, repays the lender, and distributes $50,000 to Sara. The allocations to Sara are valid because they produced the same results as if the partnership agreement satisfied the economic effect safe harbor.

Examination Techniques

- Obtain not only the partnership agreement, but also any other documents which describe the business deal – letters, loans, guarantees, indemnification, that is, any collateral arrangement which could affect a partner's rights and obligations.

- Compare the allocations in the partnership agreement with those actually made on the tax return. If there are differences, ask for an explanation and supporting documents.

- Determine the nature of the partnership's debt. Pursue a substantial economic effect analysis only in the context of recourse debt.

- Review the partnership agreement for the three requirements of economic effect contained in Treas. Reg. section 1.704-1(b)(2)(ii).

- Before proposing adjustments, be sure to consider the economic effect equivalence test, the "dumb but lucky" rule. Some unsophisticated or very old partnership agreements might not contain the three requirements of economic effect, but the allocations might still have economic effect equivalence.

Supporting Law

IRC section 704(b)
Supporting Regulations:

Economic Effect	section 1.704-1(b)(2)(ii)
Alternate Test for Economic Effect	section 1.704-1(b)(2)(ii)(d)
Economic Effect Equivalence	section 1.704-1(b)(2)(ii)(i)
Partnership Agreement Defined	section 1.704-1(b)(2)(ii)(h)

Orrisch v. Commissioner, 55 T.C. 395 (1970)
In this case, the partnership agreement was amended to allocate all of the depreciation on two buildings to Orrisch. The agreement provided that gain on the sale of partnership property would be charged to Orrisch's capital account to the extent of the depreciation allocations, and the remainder shared according to partnership interests.

Although the capital accounts were to reflect a chargeback in the event of a gain, the allocation lacked substantial economic effect because the adjusted capital accounts were not to provide the basis for liquidating distributions. Additionally, Orrisch was not required to make up his capital account in the event that the property was sold at a gain less than the allocated depreciation.

Goldfine v. Commissioner, 80 T.C. 843 (1983)
In this case, Goldfine, an affluent attorney, and Blackard, a real estate developer formed a partnership to own and operate an apartment complex. The partnership agreement called for an equal split of the proceeds of any sales of partnership property, cash distributions on refinancing, or liquidation. All of the depreciation was allocated to Goldfine, a high bracket taxpayer, and all of the income computed without depreciation was allocated to Blackard (who had net operating losses from other activities). The court concluded the allocations did not have substantial economic effect and commented that "Bargaining for tax benefits does not establish a business purpose".

Miller v. Commissioner, T.C. Memo 1984-336
Allocations of all the partnership's depreciation to Miller were found not to have substantial economic effect. The partnership agreement made no provisions for the special allocations to be reflected in Miller's capital account and provided that upon liquidation, proceeds would be divided based on ownership percentages and not based on capital account balances. The court

concluded that Miller did not bear the economic burden of the depreciation deduction allocations.

Martin Magaziner v. Commissioner, T.C. Memo 1978-205
In this case, the partnership agreement called for a substantial portion of the interest and depreciation deductions in the early years of the partnership to be allocated to Magaziner, a dentist. The property was sold at a gain in Year 6 and Magaziner received more than half of the proceeds while the taxable gain was divided equally.

The court concluded that the special allocations to Magaziner did not have substantial economic effect since they did not affect the dollar amounts Magaziner received from the partnership.

Substantiality Test

Even if an allocation passes the economic effect test, it must still be considered to be substantial. The substantiality test is designed to prevent abusive allocations which are motivated by the partners' individual tax profiles. Unlike the economic effect test, the substantiality test is not strictly mechanical.

An allocation is considered to be substantial if there is a reasonable possibility that it will affect the amount of money partners will receive independent of tax consequences. If a tax savings occurs for one or more partners in the partnership and the economic sharing arrangement is unaltered, then the allocation probably lacks substantiality. It is impossible to evaluate substantiality without knowing the tax profiles of the partners receiving the allocations. Thus, analyzing allocations for substantiality involves looking beyond the partnership return.

Emphasis: It is impossible to evaluate substantiality without knowing the individual tax profiles of the partners involved.

Tests for Substantiality

The regulations contain one affirmative test and three negative tests for determining substantiality. The affirmative test, which is the general rule, states that an allocation is substantial if it has a pre-tax dollar effect. In other words, the allocation affects the amount of money to be received by the partners independent of tax consequences.

The three types of insubstantial allocations described in the regulations are as follows:

1. "Some Help, No Hurt" allocations

2. Shifting character allocations
3. Transitory allocations

"Some Help, No Hurt" Allocations

This rule is also known as the **overall-tax-effect rule**. This rule looks at the partners as a group and takes into consideration the individual tax profiles of the partners in determining the overall tax effect of an allocation. The rule states that if the after-tax economic consequences of at least one partner will be enhanced as a result of the allocation, and no partner's after-tax economic consequences will be hurt, then the allocation lacks substantiality. This is true even if the allocation may affect the actual dollar amounts to be received by the partners.

Example 6-4

Stewart and Walt are partners in a profitable partnership which owns and manages an apartment building. They have split the profits 50/50 since the inception of their partnership. Walt is also a partner in a shopping mall partnership in which Stewart is not involved. Due to the loss of several major tenants, the shopping mall partnership lost a significant amount of revenue and generated a large pass-through loss on Walt's individual return for the year 2000.

Prior to filing their apartment partnership's return for tax year 2000, Walt and Stewart decide to amend the partnership agreement to allocate 100 percent of the partnership's income to Walt. The amendment is made knowing that Walt's loss from his other partnership will completely absorb the special allocation of income.

This allocation is insubstantial because it exploits the different outside tax profiles of the partners in order to get an after-tax benefit for one of the partners without hurting the other partner.

Shifting Allocations

A shifting allocation reduces the partners' overall tax liabilities in a given year without altering their capital account balances. In other words, while the partners may be allocated the same amount of income or loss, the partners attempt to select the character that will interact in the most favorable manner with their own individual tax profiles. A straightforward example would be one in which a partner with a large net operating loss carryforward is allocated all of the partnership's taxable dividends while a high tax bracket partner is allocated an equal amount of the partnership's tax exempt interest income. Since capital account balances reflect

amounts and not character, a pure capital account analysis of this situation would not indicate that the allocation lacked substantiality.

Example 6-5

D and M are partners in partnership DM. D also owns another business that has created a large carryforward net operating loss. M is a high tax bracket taxpayer. DM expects income both from its business operations and from interest in municipal bonds. The partnership agreement allocates all income from interest in the municipal bonds to M and an equal amount of income form DM's business operations to D. The remaining income from business operations is shared equally. D will use his carryforward net operating loss to offset the income allocation he receives from DM. M is also in a good tax position because he is a high tax bracket taxpayer and is being allocated tax-free income. This transaction lacks substantiality because there is no pre-tax effect on the capital accounts, yet there is an after-tax advantage to the special allocation.

Transitory Allocations

Transitory allocations occur over 2 or more years. An allocation is considered transitory when an original allocation is offset by a reversing allocation in the future and there has been a tax savings for one or more partners. In other words, if the allocations taken as a whole produce a wash in the capital accounts, and there has been a tax savings for one or more partners, then the allocations may be considered to be transitory.

In analyzing whether or not allocations are transitory, the regulations begin the analysis when the suspect allocations become a part of the partnership agreement. If, from the beginning, there is a strong likelihood that the allocations taken as a whole will leave the capital accounts unaffected, and one or more partners has a tax savings, then the allocations will not be respected.

Example 6-6

Rod and Chris are partners in a partnership which owns a single tenant commercial building. The tenant, a financially sound business, has given them a ten-year lease. Because Rod and Chris wanted to entice the tenant to their building, they structured the lease to have a below market rent in the first two years. Rod is a high bracket taxpayer who plans to dispose of other real estate at a gain over the next 2 years. Chris has a net operating loss carryforward and would not immediately benefit from an allocation of loss. The partners agree that Rod will be allocated the partnership's rental losses

in the first 2 years of the lease. Rod will receive an income chargeback in years three and four, and thereafter the partners will split the income 50/50.

The allocation of loss to Rod during the first 2 years would probably be considered to be an insubstantial transitory allocation. When the allocation became part of the partnership agreement, there was a strong likelihood that the allocations would produce a tax savings for Rod and that the allocations would produce a wash in his capital account.

Transitory Allocation Safe Harbors

The regulations discuss three instances in which allocation which would otherwise be deemed to be insubstantial transitory allocations will be respected:

1. Riskiness
2. Five Year Rule
3. Value Equals Basis Rule

Riskiness

Transitory allocations hinge on blending predictable future events with taking advantage of the partners' individual tax profiles. The level of risk involved in the partnership's contemplated business transactions have a bearing on whether or not at the outset there is a strong likelihood that there will be a tax savings with capital accounts remaining neutral.

As stated in this chapter's overview, one of the reasons the Code permits special allocations is to provide entrepreneurs with the ability to apportion risk. If the allocations produce a bona fide shifting of entrepreneurial risk from one partner to the other, rather than a mere tax savings, the allocations will be respected.

Example 6-7

Jim and Marc form a partnership to set up a new Internet-related business. Since Jim has started other successful technology related businesses, he is a high bracket taxpayer and would like to be allocated all losses during the initial years of the new partnership's business. The partners agree that Jim will receive all losses until the partnership becomes profitable. All profits will be allocated to Jim until he has recovered his losses and then the partners will share equally in profits and losses.

This example differs from Example 6-1 in that it is unknown if the business will be successful. At the time the allocations are made a part of the partnership agreement, it cannot be said that there is a "strong likelihood" that the capital accounts will be left neutral or that Jim will have a tax

savings. If the business takes off in the first year, Jim will have more taxable income. If the business fails, the losses in Jim's capital account will never be recovered.

Five Year Rule

If there is a strong likelihood that the offsetting allocations will not be made within 5 years of the original allocation, the transitory allocation may be respected. Treas. Reg. section 1.704-1(b)(2)(iii)(c). The 5-year rule presumes that a sufficient level of risk exists for the allocations to be considered substantial.

Value Equals Basis

Offsetting allocations can come from income chargebacks or gain chargebacks. A gain chargeback occurs when gain on the disposition of partnership property is allocated to the partner who received earlier losses from the property, generally the partner who received depreciation deductions. The gain chargeback will restore the decrease in the partner's capital account caused by the original allocations of depreciation.

Such a fact pattern could be viewed as transitory because it involves original allocations of loss which are reversed by later offsetting allocations from gain on the disposition of property, potentially leaving the capital accounts neutral. This situation, however, is protected by the value equals basis rule.

The value equals basis concept presumes that the property's basis is the maximum amount of value that the partnership can ever obtain to pay a creditor. Thus, although offsetting income allocations could come from the disposition of the property that gave rise to the original loss allocations, the regulations ignore this possibility and assume, however unrealistically, that the value of the property will never exceed its basis.

Therefore, depreciation deductions are presumed to reflect true economic loss, regardless of what is happening in the real world. This presumption protects allocations of loss caused by deprecation and later offset by an allocation of gain on the sale of property from being attacked as transitory allocations.

Examination Techniques

- Obtain and review the tax returns or RTVUEs of the partners to ascertain the individual tax profiles of the partners

- Review all amendments to the partnership agreement ─ was the partnership agreement amended after the end of the taxable year and before the filing of the return?

- Take into account the character of the special allocation item

Supporting Law

IRC section 704(b)
IRC section 761(c)
Supporting Regulations:

General Rule	section 1.704-1(b)(2)(iii)
Some Help, No Hurt	section 1.704-1(b)(2)(iii)
Shifting Allocations	section 1.704-1(b)(2)(iii)(b)
Transitory Allocations	section 1.704-1(b)(2)(iii)(c)
Amendments to partnership agreements	section 1.761-1(b)(4)(vi)

Revenue Ruling 99-43 ─ The Service ruled that partnership special allocations lacked substantiality under Treas. Reg. section 1.704-1(b)(2)(iii). The partnership allocated all of its cancellation of indebtedness income to the insolvent partner who would be able to exclude it from his gross income. Book loss from the revaluation of partnership property lowered the partners' capital accounts. These allocations did not produce any net effect on the partner's capital account but produced an overall tax savings.

Allocations Attributable to Non-recourse Deductions Test

The special rules in Treas. Reg. section 1.704-1(b)(4) refer the reader to Treas. Reg. section 1.704-2 that covers the rules pertaining to non-recourse deductions.

As stated previously, a non-recourse debt is one in which the lender can only look to the property securing the debt, and not to the partners, for repayment. In a pure non-recourse situation, the lender can foreclose on the property but cannot take collection action against the partners. The non-recourse deduction rules are particularly important in connection with real estate partnerships where borrowing on a non-recourse basis is a common business practice.

The proceeds from non-recourse borrowing can be included in the basis of depreciable property. Depreciating property secured by non-recourse debt is one way of creating non-recourse deductions.

An allocation of deduction or loss which is attributed to a non-recourse liability cannot have economic effect because no partner bears the economic risk of loss.

The regulations in section 1.704-2 provide a safe harbor for allocating deductions and loss attributable to non-recourse debt. The regulations have two main goals. One is to tie the partnership's allocation of non-recourse deductions to other items in the partnership which do have substantial economic effect. By doing this, the regulations attempt to establish a rational relationship between the partner's economic interest in the partnership and his or her share of the non-recourse deductions. The second goal is to ensure that partners who have received non-recourse deductions will also receive an appropriate share of minimum gain.

Partnership Minimum Gain

It is impossible to understand how non-recourse deductions are properly allocated without understanding the concept of minimum gain. In evaluating non-recourse deductions minimum gain, as opposed to economic effect, is the focus. Minimum gain is created as the partnership claims deductions, typically depreciation, that decrease the partnership's basis in the property below the balance of the non-recourse debt securing the property.

Emphasis: A partnership with non-recourse debts and negative capital accounts has minimum gain.

> **Example 6-8**
>
> Assume a partnership owes one million dollars in non-recourse debt which was used to acquire depreciable property for one million. If the partnership takes a $200,000 depreciation deduction, the basis of the property is now only $800,000. The amount by which the debt exceeds the basis, in this case $200,000, is the amount of the minimum gain.

The concept of minimum gain came out of a 1983 court case, ***Commissioner v. Tufts***. In that case, a non-recourse lender foreclosed on an apartment building whose fair market value had fallen below the amount of the outstanding debt. When a borrower surrenders property to a lender in exchange for debt relief, the transaction is treated as a sale or exchange. The petitioner in Tufts argued that the amount realized was the fair market value of the property. The court determined that the amount realized by the borrower included the full amount of the non-recourse debt.

If the basis of the property is less than the outstanding amount of the non-recourse debt, there is a potential taxable gain on the disposition of the property regardless of its fair market value. This potential gain is referred to as the minimum gain.

Emphasis: Simply put, minimum gain is the spread between the property's basis and the amount of non-recourse debt encumbering the property.

Minimum gain is created in the following ways:

- Deductions (generally depreciation)
- Refinancing of non-recourse debt
- Conversion of a recourse debt to a non-recourse debt

Minimum Gain Chargeback

Another key to understanding non-recourse allocations is the concept of minimum gain chargeback. The general idea behind the minimum gain chargeback is that a partner who receives the tax advantage of a deduction for which he or she bears no economic risk of loss (such as depreciation deductions generated by basis created by non-recourse borrowing) may bear a tax liability in the future due to the allocation of income. This allocation of income is called a "minimum gain chargeback". At the appropriate time, income must be allocated to the partner who received the corresponding non-recourse deductions.

The allocation of income to partners who received non-recourse deductions – minimum gain chargeback ─ is triggered when there is a decrease in minimum gain. A net decrease in partnership minimum gain occurs when

- Debt is repaid
- Taxable disposition of the property encumbered by the debt
- A non-recourse liability is converted to a recourse liability

Emphasis: Minimum gain chargeback refers to the allocation of income to partners who previously received non-recourse deductions. This occurs when there is a decrease in minimum gain.

Exceptions to the Minimum Gain Chargeback Requirement

The general rule is that a net decrease in partnership minimum gain creates a minimum gain chargeback to the partners who previously received the non-recourse deductions. There are, however, instances in which a decrease in minimum gain will not necessitate a chargeback. The most common ones are:

- If the amount of non-recourse debt decreases because it was converted to recourse debt for which partners will bear the economic risk of loss, then the partners will not be subject to a minimum gain chargeback. If the debt is converted to recourse with respect to some partners, but not others, then the partners who do not assume any economic risk of loss, as defined in the

752 regulations will be allocated minimum gain. Future allocations will be evaluated using the substantial economic effect rules.

- If a partner contributes his or her own money to pay down the non-recourse debt or increase the basis of the property, minimum gain will decrease but no chargeback is necessary. In this case, the partner has "restored" her prior non-recourse deductions with her own money; therefore an allocation of minimum gain is not necessary.

Safe Harbor Allocation of Non-recourse Deductions

Allocations of non-recourse deductions will be deemed to be made in accordance with the partners' interests in the partnership if the following requirements are met:

1. Book capital accounts are maintained in accordance with the economic effect safe harbor rules, liquidating distributions are made in accordance with positive capital account balances, and the partnership agreement either contains an unlimited deficit restoration obligation or a qualified income offset.

2. The manner in which the partnership allocates non-recourse deductions among the partners must meet a consistency requirement. This means that the allocation of non-recourse deductions must be made in a manner similar to the allocation of items which do have substantial economic effect. Thus, a partnership would not be able to allocate all depreciation deductions to one partner while allocating all other items on a 50/50 basis.

3. The partnership agreement must have a minimum gain chargeback provision.

4. 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).

The second requirement attempts to tie the allocation of non-recourse deductions to other items in the partnership which have substantial economic effect. For example, if the partnership agreement splits all of a partnerships items of income, gain, and loss 50/50, it would be inconsistent to allocate one partner 90 percent of the partnership's non-recourse deductions. Partners with straightforward allocations of economic profit and loss will most likely allocate their non-recourse deductions along the same lines.

If the partnership agreement has a more complex economic sharing arrangement, non-recourse deductions may be allocated within a certain range and still meet the consistency requirement. The example given in Treas. Reg. section 1.704-2(m)(ii)-(iii) articulates this point. If a partnership has an initial sharing arrangement between

a limited and a general partner of 90:10 which changes at the partnership's break even point to a 50:50 split, then allocating non-recourse deductions on any ratio between 90:10 and 50:50 will meet the consistency requirement. An allocation of 99:1, however, would not be considered to be consistent, with other items which do have substantial economic effect.

Supporting Law

IRC section 704(b)
Treas. Reg.section 1.704-2:

Definition of Non-recourse Liability	section 1.704-2(b)(3)
Partnership Minimum Gain	section 1.704-2(d)
Safe Harbor Requirements	section 1.704-2(e)

Resources

Federal Taxation of Partnerships and Partners, William S. McKee, William F. Nelson, Robert L. Whitmire (Publisher: Warren, Gorham & Lamont) (3rd Ed. 2001)

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"IRS Provides Guidance on Special Partnership Allocations of COD Income", **The Tax Advisor** (December 1999)

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Allocation of Tax Credits

It is impossible to evaluate whether or not a tax credit was properly allocated without first understanding the nature of the credit, the nature of the debt being used to finance the property (recourse or non-recourse), and the complex rules of IRC section 704(b) concerning economic effect, substantiality, and the allocation of non-recourse deductions. A basic understanding of the principles presented in this chapter is necessary in order to determine if the allocation of credits should be respected.

The Tax Code has numerous provisions for tax credits. The credits most commonly seen in the partnership context are the low-income housing credit under IRC section 42 and the rehabilitation tax credit under IRC section 47. The rehabilitation credit is part of the investment tax credit. Both the investment tax credit and the low-income housing credit fall under the IRC section 38, General Business Credit.

The regulations treat the allocation of the investment tax credit (which includes the rehabilitation credit) differently from other credits. For this reason, the allocation of the rehabilitation credit will be discussed separately.

Tax Credits In General

In general, tax credits do not impact the partners' capital account. They, therefore, have no effect on the dollar entitlements of the partners in terms of cash distributions or cash upon liquidation. Thus, an allocation of a credit cannot have substantial economic effect and must be allocated according to the partners' interests in the partnership.

There is no specific, mechanical, safe harbor for allocating tax credits. The regulations state that if a partnership expenditure that gives rise to a tax credit and also gives rise to valid allocations of loss or deduction, then the credit will be allocated in the same manner as the loss or deduction which decreases the partners' capital accounts. The regulations also state that identical principles apply with credits that arise from gross receipts of the partnership. Treas. Reg. section 1.704-1(b)(4)(ii).

Example 6-9

Development Corp., a real estate developer, is a partner in a low-income housing partnership. The other partner is an investment partnership. Profits and losses are split 50/50, with the depreciation and low income housing credit specially allocated 99 percent to the investment partnership and 1 percent to Development Corp. The debt is recourse debt from an unrelated lender and both partners are general partners. Assume that the partnership's allocation of depreciation, 99 percent to the investment partnership, has substantial economic effect under IRC section 704-1.

Since a partnership expenditure gives rise to the tax credit (the building's qualified basis) and also gives rise to a valid allocation of partnership deduction (depreciation) which reduces the capital accounts, the allocation of tax credit 99 percent to the investment partnership partner will be respected.

In the above example, the allocation of credit is respected because its associated allocation of depreciation deduction is respected. The allocation of credit parallels the allocation of depreciation.

In analyzing whether or not credits are properly allocated, it is critical to determine if the "other valid allocation" to which the credit is tied is to be analyzed using the economic effect rules of Treas. Reg. section 1.704-1(b)(2) or the rules in Treas. Reg. section 1.704-2 concerning the allocation of non-recourse deductions.

In the above example, if the debt were non-recourse, the depreciation deductions would lack economic effect to the extent that they were attributable to the debt because no partner bears the economic risk of loss for them. Non-recourse deductions must be allocated either in accordance with the partners' interests in the partnership under Treas. Reg. section 1.704-1(b)(3) or under the safe harbor non-recourse deduction provisions under Treas. Reg. section 1.704-2(e).

The second requirement of the non-recourse deduction safe harbor presents an area of concern in evaluating the allocation of a tax credit in a non-recourse context. This consistency requirement stipulates that allocations of non-recourse deductions are allocated in a manner that is reasonably consistent with some other "significant" partnership item (other than a minimum gain chargeback) having substantial economic effect. This item must be attributable to the property securing the non-recourse debt.

Example 6-10

The facts are the same as in Example 6-9, but the debt is non-recourse debt. The partnership agreement meets the non-recourse debt safe harbor under Treas. Reg. section 1.704-2(e). The partnership agreement calls for allocating depreciation in accordance with the allocation of a significant partnership item that has both substantial economic effect and related to the property secured by the non-recourse debt. The allocation of the credit in accordance with the allocation of depreciation will be respected.

Banks often become investors in low income housing partnerships. If a bank acts as a non-recourse lender in addition to being a partner, the bank is considered to bear the economic risk of loss to the extent that the liability is not borne by another partner. Treas. Reg. section 1.752-2(c)(1).

Example 6-11

A real estate development corporation and a bank form a partnership to develop low-income housing. The bank acts as the lender and provides non-recourse financing. The partnership agreement calls for profits and losses to be split equally with all of the depreciation and credit being allocated to the bank. In this case, the special allocation of depreciation and tax credit to the bank would be evaluated under the economic effect rules since the bank bears the economic risk of loss. As long as the allocation of depreciation to the bank has substantial economic effect, the allocation of the credit will be respected.

Rehabilitation Credit

Unlike the low-income housing tax credit, the rehabilitation tax credit does have an impact on the partners' capital accounts. The partnership must reduce the depreciable basis of the building by the amount of the rehabilitation tax credit. Similarly, a partner must reduce his capital account by his ratable share of the rehabilitation tax credit.

The rule for allocating the rehabilitation tax credit is found in Treas. Reg. section 1.46-3(f)(2). The general rule is that each partner's share of the rehabilitation costs is based on the general profit ratio of the partnership. This ratio should reflect the partners' real economic sharing arrangement.

The exception to the general rule is that a special allocation is possible if:

1. All related items of income, gain, loss, and deduction with respect to the property are specially allocated in the same manner, and

2. Such allocation is made either in accordance with the partner's interest in the partnership or has substantial economic effect.

Example 3 in Treas. Reg. section 1.46-3(f)(3) discusses a partnership engaged in the business of renting equipment whose cost qualified for the investment tax credit. Under the partnership agreement, the income, gain or loss on disposition, depreciation and other deductions attributable to the equipment are specially allocated 70 percent to one partner and 30 percent to the other partner. The conclusion is that if this allocation is made in accordance with the partners' interests in the partnership or has substantial economic effect, the cost of the equipment (and therefore the tax credit) will be taken into account 70 percent by one partner and 30 percent by the other partner.

These regulations do not permit the flexibility of separately allocating items being generated by the same property. It would not be possible to sever the depreciation and credits from other items of deduction or income being generated by the same property. All related items of income gain, loss, and deduction from a particular property must be allocated together. Additionally, such allocation must meet the other requirements of IRC section 704(b).

Example 6-12

A real estate professional and a bank form a partnership to rehabilitate and rent a historic building making equal contributions. The bank is also acting as the partnership's lender. The bank is to receive 99 percent of the depreciation deductions and 99 percent of the rehabilitation credit. All other profits and losses are to be split 50/50. The partnership will maintain capital accounts in accordance with the regulations, positive capital account balances will be respected upon liquidation, and the partnership agreement contains an unlimited deficit restoration agreement. The debt is recourse debt.

In this example, the allocation of the tax credit 99 percent to the bank will not be respected because a) it is not in accordance with the general profit sharing ratio of the partnership and b) the income, loss, and deductions are not allocated in the same manner. The credit will be reallocated in accordance with the partners' interests in the partnership (50 percent each).

Examination Techniques

Credits in General

- Determine the nature of the credit.
- Determine what expenditure or receipt is most closely associated with the creation of the credit.
- Review the partnership agreement to discern the business deal (partners' interests in the partnership) or to verify that the requirements for substantial economic effect are present.
- Verify that the item most closely associated with the credit is allocated properly and that the credit is allocated in the same manner.

Investment Tax Credits (Including Rehabilitation Credit)

- Check to see if all items being generated by the property (income, gain, loss, deduction) are allocated in the same manner.

- Review the partnership agreement to discern the business deal (partners' interests in the partnership) or to verify that the requirements for substantial economic effect are present.

Supporting Law

Allocation of Credits	Treas. Reg. section 1.704-1(b)(4)(ii)
Allocation of Section 38 Credits	Treas. Reg. section 1.46-3

Resources

Corporate Investment in the Low-Income Housing Tax Credit, **The Journal of Taxation,** December 1993, Peter M. Lampert

Chapter 7

Dispositions of Partnership Interest

INTRODUCTION

A partner can dispose of a partnership interest in the following ways:

- By sale to one or more of the other partners.
- By sale to a third party.
- By exchange of the partnership interest for other property.
- By transfer back to the partnership in return for at least one liquidating distribution leading to a complete liquidation of the partnership interest.
- By retirement.
- By gift or contribution.
- By death.
- By surrendering the partnership interest through abandonment, forfeiture, or worthlessness of the partnership interest.

Each of the above methods for disposing of a partnership interest is covered in this chapter.

This chapter also addresses:

- The character of the gain or loss on the disposition of a partnership interest.
- The effect of related debt disposition.
- The recognition of accumulated suspended passive losses associated with a partnership interest.

ISSUE: SALE OR EXCHANGE OF A PARTNERSHIP INTEREST

Under subchapter K, the rules for the disposition of a partnership interest follow the entity theory of partnership taxation. All determining factors of the disposition (for example, basis, holding period, and character of the gain or loss) are

considered with respect to the partnership interest without reference (except for IRC section 751 assets) to the underlying assets of the partnership.[1]

IRC section 741. Recognition and character of gain or loss on sale or exchange

In the case of a sale or exchange of a partnership interest, gain or loss shall be recognized by the transferring partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in IRC section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value). However, the substantially appreciated requirement under IRC section 751(a), relating to the sale or exchange of a partnership interest, has been repealed by the TRA '97 (Refer to 1997 TRA for effective dates), therefore, disregard that requirement.

Calculation of Gain or Loss

The gain or loss from the disposition of a partnership interest is the difference between the amount realized and the partner's adjusted basis (outside basis) in the interest immediately before the disposition. Although the formula for calculating gain or loss is simply stated, addressing each component in detail is essential.

The amount realized consists of cash plus the fair market value of property received plus the selling partner's share of partnership liabilities assumed by the buyer (IRC section 752(b)).

The adjusted basis of the partnership interest begins with the original partnership basis as determined under IRC sections 722 or 742, relating to the original acquisition of the partnership interest. It is increased by those items specified in IRC sections 705(a)(1) and 752(a) and decreased by those specified in IRC sections 705(a)(2) and 752(b). At the time of the sale or exchange, IRC section 752(d) treats the selling partner's share of partnership liabilities in the amount realized in much the same way as IRC section 752(b) treats a deemed distribution.

Because the transferring partner's basis in the partnership must be determined as of the date of disposition, any adjustments to basis must also include the transferring partner's share of partnership income or losses from the beginning of the partnership year to the date the partner ceases to be a partner.

Characterization of Gain or Loss

In conjunction with the determination of any gain or loss to be recognized by the disposing partner, in the presence of IRC section 751 assets, a separate calculation will be required to determine the portion of the transaction to be considered capital and the portion to be treated as ordinary. When the sale of the partnership interest

[1] Because IRC section 741 sets the framework for the tax treatment of the sale or exchange of a partnership interest, it has been incorporated herein, as an essential part of this text.

includes both **cold assets** (capital assets) and **hot assets** (assets with built in ordinary income potential), the sale is said to be bifurcated (split) into two components, capital gains and losses from the cold assets, and ordinary gains and losses from the hot assets.

Further complications arise when a single asset has both hot and cold asset attributes subject to the recapture provisions of IRC section 751(c). IRC section 751(c) treats the amount to be recaptured as an unrealized receivable. Upon the sale of a partnership interest, recapture will generate ordinary income even though depreciable assets are capital assets (Treas. Reg. section 1.751-1(c)(4)). The ordinary income component of the gain is computed first. Any remaining amount of the gain is capital.[2]

The disposing partner's ordinary gain or loss is the difference between the amount realized attributable to IRC section 751 assets less the partnership's adjusted basis associated with these items.

The sale of a partnership interest resulting in a gain can be reported under the installment method under IRC section 453 if at least one payment is received after the year of sale. A sale resulting in a loss cannot be reported under the installment method (IRC section 453(a)).

Additional Filing Requirements

Generally, IRC section 6050K requires that a Form 8308, Report of a Sale or Exchange of Certain Partnership Interests, must be filed for each sale or exchange of a partnership interest which contains IRC section 751 property. (The Forms 8308 are to be filed as an attachment to the partnership's Form 1065.) The penalty for the partnership's failure to file Form 8308 is governed by IRC section 6721. There is generally a $50 penalty imposed for each infraction or violation.[3]

IRC section 706(c)(2)(A) provides that the taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates. Additionally, IRC section 708(b)(1)(B) generally provides for the taxable year of the partnership to close if there has been a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period.

Exchanges of Partnership Interest

There are many ways to exchange partnership interests. The most common ways are to:

- Exchange an interest in one partnership for an interest in another partnership.

[2] IRC section 751 is discussed more fully in Chapter 4.
[3] IRC section 1.6050K-1(a)(3) provides filing alternatives for partnerships required to make 25 or more Form 8308 filings in one tax year.

- Exchange a limited partnership interest for a general partnership interest in the same partnership.

- Exchange a partnership interest for a direct ownership right to all or part of a partnership asset.

- Exchange a partnership interest for a member interest in a successor LLC or LLP.

- Exchange of a partnership interest for corporate stock while incorporation of the partnership.

The exchange of a partnership interest in one partnership for an interest in another partnership will result in gain or loss recognition, even if both partnerships own like-kind property. IRC section 1031(a)(1) generally provides for non-recognition of gain or loss on exchange of particular properties of like kind. Exchanges of partnership interests, however, are specifically excluded from IRC section 1031 by IRC section 1031(a)(2)(D).

The exchange of a partnership interest for a different partnership interest in the same partnership as part of a conversion of the partnership from general liability to limited liability or vice-versa, is generally a non-recognition event. See Rev. Rul 84-52, 1984-1 C.B. 157. Also, the conversion of an interest in a domestic partnership into an interest in a domestic LLC classified as a partnership for federal tax purposes (and visa-versa) is treated generally like a partnership to partnership conversion pursuant to Rev. Rul. 84-52. See Rev. Rul. 95-37, 1995-1 C.B. 130.

The exchange of a partnership interest for a direct ownership right to all or part of a partnership asset is essentially a distribution in liquidation of the partnership interest. Such an exchange was at issue in ***Chase v. Commissioner***, 92 T.C. 874 (1989). The Tax Court determined that the substance over form doctrine applied and the transaction failed to qualify for non-recognition under IRC section 1031. See IRC section 1031(a)(2)(D). ***Chase v. Commissioner*** should be cited in situations where the form of the transactions fail to reflect the economic realities of the transactions.

The **exchange of a partnership interest for corporate stock** can result in taxable income to the transferring partner if the FMV of the stock received exceeds the adjusted basis of the partnership interest transferred. If IRC section 351 is applicable, the exchange may not be taxed. In a qualified IRC section 351 exchange, however, liabilities assumed by the corporation that are in excess of the partner's tax basis in the partnership interest and other assets contributed to the corporation for the stock will trigger a gain under IRC section 357(c).[4]

[4] IRC section 351 will not be discussed in this ATG but should be researched in other sources. See 2 William S. McKee,William F. Nelson & Robert L Whitmire, Federal Taxation of Partnerships and Partners §15.07 (3rd edition 1997).

Note:
Unless there is an IRC section 754 election in effect, the inside basis of partnership assets are not changed as a result of the sale or exchange of a partnership interest. If there is an IRC section 754 election in effect, the inside basis of partnership assets is adjusted to reflect the purchase price but only for the partner who acquired the partnership interest. Application of the adjustment serves to eliminate the discrepancy between the purchasing partner's inside and outside bases.[5].

Examination Techniques

As can be expected from the myriad of tax consequences that may result from the sale or exchange of a partnership interest, the selling partner will be looking to reduce the tax effects of any gains and to stretch the tax benefits of any losses on the sale.

After determining that there has been a sale or exchange, the character of the gain or loss must be determined. This is accomplished through an analysis of each asset transferred in the transaction or series of transactions.

What did the seller/transferring partner receive? What did the taxpayer relinquish? What additional benefits accrue as a result of the sale or exchange? Review the facts and circumstances surrounding the partnership interest and the taxpayer's relationship to the recipient of the partnership interest and the remaining partners. Do not let the elaborately structured **form** of the transaction overshadow its actual **substance**.

Issue Identification

The initial indication that a partner has disposed of a partnership interest should be evident from the partner's Schedule K-1. A change in a partner's ownership percentages of profits, capital, or losses from the beginning of the tax year to the end of the tax year as reported on the Schedule K-1, may indicate either a disposition of part or all of the partner's ownership interest. A reduction of a partner's ownership interest to an amount other than zero may be indicative of a partial sale, exchange, or liquidation. It should be noted, however, that such a reduction may also be related to changes in the partnership agreement or a partnership's attempt to reflect more accurately the intent of the partnership agreement.

Exchanges between partners of their ownership interest in profits, losses, and capital, as reported on their Schedules K-1, should be scrutinized as they may alter the allocation of distributive items. In short, these exchanges may not be supported by bona fide transactions between the affected partners.[6]

[5] For a discussion of optional basis adjustments, see Chapter 3.
[6] See Chapter 6, Income Allocation, for a discussion of substantial economic effect.

If there is any increase in a partner's ownership interest in profits, losses, or capital or the addition of a new partner, the Schedule K will generally identify the parties involved.

Review item J of theSchedule K-1, Analysis of partner's capital account, especially when there is a negative capital account interest at the beginning of the year and a zero capital account interest at the end of the year. This review, along with a scrutiny of partnership debt appearing on the balance sheet, and a review of more than one year's Schedule K-1, Item F, Partner's share of liabilities, may lead to a conclusion that there have been events that qualify as deemed distributions pursuant to IRC section 752(b).

If the partner's capital account was reduced to zero, check for amounts on any of the distribution lines on the Schedule K-1. No distribution may be an indication that there was a sale, while a distribution may be a sign of a liquidation by way of a distribution.

Does the balance sheet show inventory? If it does, consider the ordinary income component (IRC section 751) of the sale.

If the partnership is on the cash method, determine if it has contracted for services to be performed in the future or for goods to be delivered at a later date. The value of these contracts may have been imputed to the selling price of the partner's interest in recognition of the value of an unrealized receivable.

The presence of depreciable assets on the balance sheet should raise questions as to whether there is a potential for depreciation recapture. Depreciation recaptured under IRC section 1245 or IRC section 1250 is treated as an unrealized receivable under IRC section 751(c) and any gain or loss recognized by the disposition of the property is traced as ordinary income or loss pursuant to IRC section 724(a).

Was Form 8308, Report of a Sale or Exchange of Certain Partnership Interests, filed with the partnership Form 1065? The presence of hot assets on the balance sheet, along with the understanding that there had been a sale or exchange of a partnership interest should raise a red flag that a Form 8308 should have been filed.

A comparison of the beginning and ending balance sheets can disclose a step-up in basis. Alternately, amounts appearing on the "Other deductions" line of Schedules K and K-1 may be an indication of additional depreciation calculated on the step-up. This item should be distributive to the purchasing partner only. This item may also be separately reported to partners who acquired their interest by purchase in prior years, at which time they received a step-up.

Transfers between family members which are identified as a gift may trigger sale or exchange treatment for the donor to the extent partnership liabilities are assumed by the donee.[7] Under IRC section 704(e)(3), the purchase of a partnership interest from a family member is treated as if created by a gift.[8]

[7] See Chapter 11, "Family Partnerships" and the discussion of bargain sales in this chapter.
[8] This feature is covered in the "Gift or Contribution" section of this chapter.

If there has been an optional basis adjustment, look for the IRC section 754 election.

The selling partner's tax return should be reviewed. If necessary, it should be examined to determine if the sale or exchange was reported correctly.

Documents to Request

1. Partnership agreement
2. Prior and subsequent years' partnership tax returns
3. Calculation of the selling partner's basis.
4. Agreement of sale between the selling partner and purchaser, including any provisions for debt assumption.
5. Calculation of built-in depreciation recapture potential.
6. Contracts for future services and/or delivery of goods to be performed by the partnership at the time of the disposition.
7. Calculation of optional basis adjustment, if any.
8. Disposing partner's tax return for the year of the disposition.

Interview Questions

Interview questions are contingent on the extent to which the documents requested present a clear picture as to how the disposition and its tax consequences were reported; specifically:

1. Were all types of IRC section 751 hot assets taken into account?

2. How were hot assets valued with respect to the selling partner's interest?

3. To what extent was the transferring partner's share of partnership non-recourse liabilities assumed by the transferee?

4. Was the disposing partner liable for recourse debt? Did the partner remain liable for the debt after disposing of the partnership interest? If the transferee takes the partnership interest subject to recourse debt, are there any agreements between the transferee and transferor which give the appearance that the transferor may nevertheless pay off the debt in the future? Consider that the obligation to the transferor may be too contingent. If that is the case, the debt becomes part of the amount realized from the sale.

5. If there has been an optional basis adjustment and there is no indication of an IRC section 754 election on the partnership return currently under exam, on what year's return, if ever, was the election first made? Is the election still in effect?

6. Any discrepancies between the determination made by the examining agent and the results of the disposition reported by the disposing partner would

require an examination of the disposing partner's tax return.[9] Questions should be designed to reconcile to the correct amount.

7. Did the transferor and transferee treat the sales price consistently with respect to hot and cold assets?

Supporting Law

IRC, Subchapter K: Section 704 - 706
Section 708
Section 722
Section 724
Section 731
Section 741
Section 743
Section 751
Section 752
Section 754
IRC section 1001
IRC section 1031
IRC section 223
IRC section 050K
IRC section 6722
Supporting regulation and specific regulations cited above.

Revenue Ruling 84-52, 1984-1 C.B. 157
The conversion of a general partner interest into a limited partner interest, and vise versa, within the same partnership, generally will result in no gain or loss recognition by the partner under section 741 or 1001 of the Code. If, as a result of the conversion, there is no change in the partner's share of liabilities section 1.752-1(e) of the Treasury Regulations, there is no change to the partner's partnership interest's adjusted basis. If there is a change in the partner's share of partnership liabilities under Treas. Reg. section 1.752-1(e), and such change causes a deemed contribution of money under IRC section 752(a) then IRC section 722 will increase the partner's adjusted basis in the partnership. If the conversion causes a deemed distribution of money under IRC section 752(b) then the partner's partnership basis shall be reduced by IRC section 733, but not below zero. The amount by which the deemed distribution exceeds the partner's adjusted basis in the partnership, will generate a gain to be recognized by the partner, as provided for in IRC section 731.

IRC section 1223(1) holds that the holding period of the acquired partnership interest becomes that of the interest converted.

[9] See Chapter 13, TEFRA, regarding partnership items and nonpartnership items.

Revenue Ruling 84-53, 1984-1 C.B. 159
This Revenue Ruling illustrates, by way of four examples, various basis allocations and adjustments that may occur when a partner owns multiple interest in a partnership and disposes of only a portion of such interests.

When considering sales and exchanges by a partner with multiple interests, the partner is deemed to have a single basis in the partnership. If the partner disposes of less than the entire partnership interest owned, then the basis allocated to the interest disposed of is determined with reference to fair market values of the interests retained and disposed. See Treas. Reg. section 1.61-1(a).

Revenue Ruling 95-37, 1995-1 C.B. 130
This ruling treats the conversion of a partnership interest into an LLC interest in much the same manner as conversions described in Revenue Ruling 84-52.

***Crenshaw v. Commissioner*, 450 F.2d 472; 1971 U.S. App. (5th Cir.)**
The Court of Appeals for the Fifth Circuit, in reviewing the facts surrounding a complex, multi-tiered transaction, found, in a case of substance versus form, that the series of transactions amounted to nothing more than a sale of a partnership interest subject to IRC section 741. The taxpayer had argued for tax-free liquidation treatment under IRC section 736(b) followed by a tax-free exchange of like-kind property under IRC section 1031.

***Pollack v. Commissioner*, 69 T.C. 142 (1977)**
The Tax Court ruled that the loss resulting from the disposition of a partner's interest in a partnership should be characterized as a capital loss pursuant to IRC section 741 rather than an ordinary business loss, as the taxpayer had claimed. Characterization of a partnership interest as a capital asset neither depends on the taxpayer's motive when acquiring the interest nor the fact that treatment would be different if the taxpayer had established the enterprise as a business other than a partnership.

Collapsible Partnerships
A collapsible partnership is the sale or exchange of an interest in a partnership by a partner prior to receipt by the partnership of unrealized receivables or inventory items which have appreciated substantially in value. See S. Rept. No. 1616, 86th Cong., 2d Sess., p. 77 1960; S. Rept. No. 1622, 83rd Cong., 2d Sess., p. 98 (1954). Any consideration attributable to such unrealized receivables or inventory items considered to be property received from the sale or exchange of property other than a capital asset. See IRC section 751(a).

It should be noted that the following cases, involved tax years that predate the 1954 Code, but the findings are consistent with the intent behind enactment of IRC sections 741 and 751.

***Trousdale v. Commissioner*, 219, F.2d 563 (9th Cir. 1955)**
In this case, the partners wanted to terminate their partnership. Essentially all of the services to be performed by the partnership had already been performed. The only assets remaining in the partnership were accounts receivable. The

partnership then disguised its dissolution as a sale. The Tax Court held and the Court of Appeals for the Ninth Circuit affirmed that the payments received were in fact for services rendered by the partnership and not for a sale of the partnership. As a result, the income was held to be ordinary income.

***Haggard v. Wood*, 298 F.2d 24 (9th Cir. 1961)**
The sole business of the partnership was the cultivation of a cotton crop. At the time of the sale, the crop was ready for harvest and market. The partners and purchaser, who were all related, took particular care, through correspondence and the agreement of sale, to depict the transaction as the sale of partnership interests and not the sale of partnership assets. The partners were paid for their partnership interests out of the proceeds the purchaser received from the sale of the cotton crop.

The Court of Appeals for the Ninth Circuit affirmed the district court's determination that the partners should recognize ordinary income from the sale of the partnership's only asset rather than capital gain from the sale of a partnership interest. In reaching its decision, the court discussed ***Trousdale v. Commissioner***.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Thomas Crichton, IV et al., 712 Tax Mgmt., Partnerships - Taxable Income; Allocation of Distributive Shares; Capital Accounts.

Kevin N. Kemp et al., 718 Tax Mgmt., Dispositions of Partnership Interests - Termination of a Partnership.

2 William S. McKee, William F. Nelson & Robert L. Whitmire, Federal Taxation of Partnerships and Partners sec. 15.07 (3d ed. 1997).

2 William S. McKee, William F. Nelson & Robert L. Whitmire, Federal Taxation of Partnerships and Partners, ch. 17 (3d ed. 1997).

Steven C. Thompson, Partnership Taxation – Fundamentals, Englewood, CO; MicroMash, Chapter 6, Sale of Partnership Interests.

Geoffrey F. Grossman, Choosing the Most Advantageous Method for Disposing of a Partnership Interest, 3 J. P'ship Tax'n 219 (Fall 1986).

Doug W. Banks & David E. Karr, Sale of Partnership Interest Can Produce Unexpected Tax Results Without Proper Planning, 38 Tax'n for Accts. 92 (Feb. 1987)

ISSUE: LIQUIDATION OF A PARTNER'S INTEREST IN THE PARTNERSHIP

There is little, if any, economic difference between a pro rata sale of a partnership interest to the remaining partners and a liquidation of the interest by way of liquidating distributions from partnership assets. Ultimately, the departing partner's interest is terminated in favor of the remaining partners. The tax effects are, however, quite different, depending on the path taken.

The following points highlight how the liquidation of a partner's interest in a partnership differs from the sale of such an interest.

- In a liquidation, the "buyer" is the partnership rather than any of the existing partners or a third party (who replaces the partner).

- In a liquidation, the partnership makes a distribution, or series of distributions, in the form of cash and/or partnership assets to the liquidating partner. IRC section 761(d).

- In a liquidation, a series of distributions may take place over a period of one or more year.

- In a liquidation, the partner's interest will not be considered liquidated until the final distribution has been made. IRC section 736(b).

- A partner owning more than one interest must terminate all of its interests in the partnership in order to qualify any distributions received as liquidating distributions. IRC section 761(d).

- A distribution not in liquidation of a partner's entire interest, is a current distribution. Current distributions include distributions in partial liquidation of a partner's interest as well as distributions of the partner's distributive share of current partnership income.

- Liquidation of a partnership interest does not trigger a technical termination of the partnership under IRC section 708(b)(1)(B) even when the liquidated interest represents 50 percent or more of the total interest in partnership capital and profits. Treas. Reg. section 1.708-1(b)(2).

- For taxable years beginning after December 31, 1997, IRC section 706(c)(2)(A) provides that the taxable year of a partnership will close with respect to a partner whose entire interest is terminated as a result of death, liquidation, or otherwise. For taxable years beginning before January 1, 1998, IRC section 706(c)(2(A) provided that the partnership's taxable year closed with respect to a partner whose entire interest was terminated as a result of sales, exchanges, or liquidation, except that the taxable year of a partnership with respect to a partner whose interest terminated as a result of death did not close prior to the end of the partnership's taxable year.

Liquidating Distributions[10]

The following points relate to distributions in complete liquidation of an interest in a partnership (although some may also apply to non-liquidating/current distributions):

- Where money (including marketable securities as per IRC section 731(c)) is distributed by a partnership to a partner, no gain shall be recognized to the partner, except, to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. See Treas. Reg. section 1.731-1(a)(i).

- A deemed distribution under IRC section 752(b) is considered a distribution of money. IRC section 752(b).

- Generally, no gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until the partner sells or otherwise disposes of the property. Treas. Reg. section 1.731-1(a)(1)(i). Exceptions to this rule are provided in IRC sections 736 and 751.

- A loss is recognized by a partner only upon liquidation of the partner's entire interest in the partnership, and only if the property distributed to the partner consists solely of money, unrealized receivables (as defined in IRC section 751(c)), and inventory items (as defined in IRC section 751(d)(2)).[11]

- Upon a liquidating distribution, loss is recognized by the distributee partner to the extent of the excess of the adjusted basis of the partner's interest in the partnership at the time of the distribution over the sum of any money distributed to the partner and the basis of any IRC section 751 assets distributed. Treas. Reg. section 1.731-1(a)(2).

- Note, the treatment of IRC section 751 assets under Treas. Reg. section 1.731-1(a)(2) serves to prevent the partner from converting capital loss to ordinary loss when disposing of IRC section 751 assets. Similar treatment does not apply if the result of the liquidation, after the distribution of money, is a gain.

- Any gain realized or loss sustained by a partner on a sale or exchange of inventory items (as defined in IRC section 751(d)) received in a distribution from a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered ordinary gain or ordinary loss. IRC section 735(a)(2); Treas. Reg. section 1.735-1(a)(2).

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[10] A discussion of partnership distributions is presented in Chapter 4. Here, however, we focus on liquidating distributions, which differ in some respects from distributions made to partners who will continue as partners after the distribution.

[11] The term "liquidation of a partner's interest", as defined in IC section 761(d), is the termination of the partner's entire interest in the partnership by means of a distribution or series of distributions. Treas. Reg. section 1.731-1(a)(2).

- Any gain realized or loss sustained on the disposition by the distributee partner of unrealized receivables (as defined in IRC section 751(c)) distributed by a partnership, shall be considered as ordinary income or ordinary loss. IRC section 735(a)(1).

- The holding period of the distributed property to the distributee includes the holding period of the partnership, except in the case of inventory items. IRC section 735(b).

- Any gain realized or loss sustained by a distributee partner in complete liquidation of a partnership interest is treated as a gain or loss from the sale or exchange of a capital asset. IRC sections 731(a) and 741.

- Under IRC section 731(b), no gain or loss is recognized by the partnership on a distribution to a partner of property, including money. However, the partnership may recognize gain or loss from certain distributions which, under IRC section 751(b), are treated as a sale or exchange of property between the distributee partner and the partnership.

Generally, in most instances of distributions of property the partner takes a carryover basis in the property distributed. However, in a liquidating distribution, the basis of distributed property in the hands of the distributee is limited to his or her outside basis **after** it has been reduced by money received.

Example 7-1

A partner with an outside basis of $1000 before distribution receives, in liquidation of his or her partnership interest, a cash distribution of $300 and partnership equipment with a basis to the partnership of $800. Since the partner has a reduced outside basis of $700 ($1000 less the cash received of $300), the equipment will have a basis of $700 to the distributee. Conversely, if the equipment had a basis to the partnership of only $200 it would still receive a basis of $700 in the hands of the distributee. **No gain or loss is reported until the distributee disposes of the equipment.**

If the distribution includes both hot and cold assets any unrealized loss would be allocated to the cold asset(s), increasing the basis of such property in the hands of the former partner. IRC section 732(c) covers the allocation of basis on distributed property. The requirement of allocating unrealized loss to cold assets only serves to prevent ordinary income from being converted to capital gain upon disposition of the hot assets by the distributee.[12]

[12] The concepts of allocation of basis under IRC section 732(b) and disproportionate distributions under IRC section 751(b) can become extremely complex and, therefore, beyond the scope of this section of the Guide. The reader is referred to Chapter 4 of this MSSP Guide and is advised to consult the underlying regulations as well as texts cited as *Resources*. Both the regulations and the referenced texts provide an excellent assortment of examples to aid in understanding these complex sections.

If the partnership makes an IRC section 754 election, optional basis adjustments can be made to the undistributed partnership property under IRC section 734(b), in accordance with the rules of IRC section 755. Such adjustments can serve to correct for differences that have arisen as a result of property distributions. These differences are triggered by the distributee taking a basis in the distributed property that is different from the basis of the property in the hands of the partnership or when the distributee recognizes gain or loss on the distribution. For further discussion of optional basis adjustments see Chapter 3 and the underlying Regulations as well as texts cited as *Resources*, all of which provide several good examples.

Examination Techniques

In the matter of liquidating distributions the examiner should be wary of instances where the partner whose interest has been liquidated may be attempting to:

- Claim losses from his or her liquidated interest at a time when the interest had not yet been fully liquidated.
- Claim a loss from a fully liquidated interest in the partnership while holding yet another interest in the partnership.
- Claim losses from a liquidated interest while ignoring deemed distributions under IRC section 752(b). Or, in general, exclude deemed distributions under IRC section 752(b) from the computation of the amount realized as distributed.
- Claim losses from distributed cold assets prior to disposing of those assets.
- Allocate basis to distributed IRC section 751 hot assets in a manner designed to reduce the impact of ordinary income recognition or convert ordinary income into capital gain.

While no gain or loss is recognized by the partnership on a distribution to a partner, with the exception of distributions under IRC section 751(b), the examiner should be alert to the following possibilities:

- The partnership may make a disproportionate distribution to avoid the full impact of IRC section 751(b).
- The partnership may attempt to expense certain items of the distribution.
- Optional basis adjustments to undistributed assets under IRC section 734(b) may be allocated in a manner designed to benefit the remaining partners in a way not intended by the statute.
- If the partnership has an IRC section 754 election in place, it may have failed to make optional basis adjustments under IRC section 734(b) which serve to reduce the basis of property remaining in the partnership.

- If there has been a deemed distribution under IRC section 752(b), the partnership may have allocated the debt in favor of a particular partner rather than proportionately.

Issue Identification

The first hint that a partner's interest had been liquidated, or is in the process of being liquidated, can be seen on the partnership return. Does the partner's Schedule K-1 contain a distribution? If it does, then it should also break down the distribution as to cash and property. This information is also available on Schedule M-2.

Does the partner's Schedule K-1 end with zero capital and no remaining share of partnership liabilities? If the Schedule K-1 shows that the partner is no longer treated as a partner at the end of the partnership year, then there may have been a complete liquidation of the partner's interest. If it is found that the partner has another interest in the partnership, as evidenced by an active Schedule K-1, then the partner's interest has not been completely liquidated.

The examiner should review the balance sheet, Schedule M-2 and other partners' Schedule K-1. If the balance sheet shows that a partner has loaned money to the partnership, or if the Schedule M-2 shows contributions to capital (Treas. Reg. section 1.731-1(c)(3)), and/or the remaining partners' Schedule K-1 show a disproportionate reallocation of the liquidating partner's profit and loss interests and capital interest, then the transaction may have been a sale rather than a liquidation.

One of the critical differences between a sale of a partnership interest and distributions in liquidation of the partnership interest is the ability to defer gain on the distribution in liquidation.

> **Example 7-2**
>
> If a partner with an adjusted basis in the partnership of $100,000 and a partnership interest with a FMV of $150,000 sells half of his interest for $75,000, the partner will be required to report a capital gain of $25,000 ($75,000 - $50,000), pursuant to IRC section 741. However, if $75,000 was distributed to the partner in partial liquidation of his partnership interest, then no current income is recognized since the total received ($75,000) is less than the adjusted basis of the partner's interest in the partnership ($100,000), immediately before the distribution. See IRC section 731(a)(1).

It is, therefore, essential that the examiner determine the source of the funds distributed by the partnership. In an issue of substance versus form, the examiner should question the validity of any amendments to the partnership agreement, or any side agreements, which cast the transaction as a distribution in liquidation.

Issue identification regarding deemed distributions under IRC section 752(b), optional basis adjustments under IRC section 734(b), consideration of IRC section 751 assets and recapture provisions are similar to those used for sales and exchanges.

The partner's return should be reviewed for possible issues regarding the distributee's treatment of gains or losses reported and basis applied to distributed property resulting from the distribution in partial or complete liquidation.

Documents to Request

Generally, the documents requested for an examination of the issue of distribution in partial liquidation or a distribution in complete liquidation should mirror that of a sale or exchange, with the exception of the documents which spell out the plans for liquidation of the partner's interest. Documents requested are in many ways similar to those requested for the retirement of a partner. The reader is referred to the "*Sale and Exchange of a Partnership Interest*" section of this chapter, as well as the section on "*Retirement or Death of a Partner*."

Interview Questions

1. Is the distribution a distribution in liquidation of a partner's interest (IRC section 731(a)(2)) or payments to a retiring partner or deceased partner's successor in interest under IRC section 736? There are significant differences, as you will see, in the section of this chapter, which covers retirement of a partner.

2. Generally, any questions directed at resolving issues of basis, capital gain and loss versus ordinary gain or loss, optional basis adjustments (with the understanding that there are differences between IRC sections 734(b) and 743(b)), etc., should be similar to questions raised for sales and exchanges of partnership interests.

3. Any discrepancies between the determination made by the examining agent and the results of the liquidating distributions or distributions in complete liquidation reported by the distributee partner require an examination of the seller's tax return.

Supporting Law

IRC, Subchapter K: Sections 731 through 737
Section 751
Section 752
Section 754
Section 755
Section 761

Supporting regulation and specific regulations cited above.

Treatment of Payments for Goodwill
Service partnerships often make payments for goodwill to liquidating partners. IRC section 736 provides that the liquidating partner and partnership may execute an agreement regarding how such payments are to be treated. IRC section 736(a) allows the partner to treat the payment for goodwill as ordinary income and the partnership to treat it as deductible. IRC section 736(b) allows for the partner to treat such payment as capital gain and the partnership is left without a deduction.

If the partnership is sold, however, IRC section 741 governs. IRC section 741 declares that the selling partner's interest in the partnership's goodwill is a capital gain to the partner and nondeductible by the partnership, regardless of any agreements between the parties.

Cases to review in this area include:

- ***Smith v. Commissioner***, 37 T.C. 1033, ***aff'd*** 313 F.2d 16 (10th Cir. 1962) (providing for the agreement between the liquidating partner and the partnership to be controlling with respect to whether a payment is for goodwill).

- ***Cooney v. Commissioner***, 65 T.C. 101 (1975) (stating that since the agreement provided that no part of a payment in liquidation was to be attributed to goodwill, the court found that it had "no latitude" and no part of such payment could be treated as goodwill).

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

2 William S. McKee, William F. Nelson & Robert L. Whitmire, Federal Taxation of Partnerships and Partners; part VI: Distributions and Part VII: Death or Retirement of a Partner (3d ed. 1997).

Steven C. Thompson, Partnership Taxation – Fundamentals, Englewood, CO; MicroMash, Chapter 7B, Liquidating Distributions

Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K: A Conceptual Guide to the Taxation of Partnerships, Chapters 11 through 13.

James A. Doering, Disposition of Less than an Entire Partnership Interest: What are the Tax Effects? 15 J. P'ship Tax'n 141 (Summer 1998)

Janet B. Wright, Liquidating the Partnership: An Analysis of the Issues and Opportunities, 14 J. P'ship Tax'n 229 (1998).

ISSUE: RETIREMENT OR DEATH OF A PARTNER

Any of the methods for disposition of a partnership interest presented in the chapter on sales and exchanges is available to a retiring partner. The two methods most commonly employed are:

- By sale to one or more of the existing partners or to a third party.
- By sale direct to the partnership.

The second method of disposition, liquidation, is discussed above. Payments in complete liquidation of a retiring partner's interest in the partnership, or a deceased partner's successor in interest, are governed by IRC section 736. Were it not for IRC section 736, retirement of a partnership interest would be indistinguishable from liquidation.

Since IRC section 736 applies to payments to both retiring partners and a deceased partner's successor in interest, any discussion in this section is applicable to both, even when only one or the other is indicated.

Payments to a retiring partner or deceased partner's successor in interest consist of:

- Payments for the partner's interest in the partnership (IRC section 736(b)).
- Payments that are considered distributive shares of partnership income if the amount is determined with regard to the income of the partnership (IRC section 736(a)(1)).
- Payments that are considered guaranteed payments described in IRC section 707(c) if the amount is determined without regard to the income of the partnership (IRC section 736(a)(2)).

It is important to recognize that the purpose of IRC section 736 is to **categorize payments** to the partners identified in its title, and only those partners (see Treas. Reg. section 1.736-1(a)(1)(ii)). After the categorization is made, the rules of the various other subchapter K sections serve their function.

Certain provisions of IRC section 736 were amended by the Revenue Reconciliation Act of 1993 (RRA '93). The changes were effective for payments to partners retiring or dying on or after January 5, 1993. There is a transition rule stating that the new rules will not apply to partners who retire or die after January 5, 1993, if there was a binding contract in effect on January 4, 1993. In these instances, the deduction of IRC section 736(a) payments made to such qualified partners will continue to be allowed to the partnership, while RRA '93 places a limitation on deductibility.

For years before the enactment of RRA '93 the tax rate gap between capital gains and ordinary income was minimal. Generally, retiring partners were indifferent

as to the treatment of payments they received under IRC section 736 in those years. So, for example, payments to the departing partner for his or her share of goodwill were treated as IRC section 736(a) payments even though goodwill is a capital asset. This allowed the partnership to take a deduction for the payment rather than treat it as a nondeductible capital expenditure. The distributive income of the remaining partners was reduced, while the departing partner did not experience any significant economic adversity from reporting this payment as ordinary income due to the insignificant tax difference between ordinary income and capital gain.

RRA '93 altered the treatment of payments under IRC section 736 by limiting the types of payments that could be classified as made under IRC section 736(a) and classifying all other payments made under IRC section 736(b), payments for the interest of the retiring partner in partnership property. RRA '93 requires that the partnership and the retiring partner agree to the inclusion of a reasonable amount of the goodwill as an IRC section 736(b) payment, thereby reducing deductions to the partnership for its payments for a capital asset. On the other hand, RRA '93 eliminates unrealized receivables (IRC section 751(c)) from IRC section 736(b) payments, thus preventing the conversion of ordinary income to capital gain. This section will concentrate on the post RRA '93 application of IRC section 736.

Payments under IRC section 736(a) are liquidating payments. These payments are unrelated to a retiring partner's interest in partnership property. Rather than being considered distributions, payments are for part of the retiring partner's distributive share of partnership income or guaranteed payments to the partner, as determined by IRC section 736(a)(1) and 736(a)(2).

The characteristics of payments under IRC section 736(a) for the departing partner, the partnership and its remaining partners are:

- Payments under IRC section 736(a)(1) are generally ordinary income to the retiring partner or deceased partner's successor in interest;

- Payments under IRC section 736(a)(2) are always ordinary income to the retiring partner or deceased partner's successor in interest;

- Payments under these two subsections serve to reduce the distributive shares of the remaining partners;

- Payments under IRC section 736(a)(1) are included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share;

- Payments under IRC section 736(a)(2) are included in the income of the recipient for his taxable year in which the partnership is entitled to deduct the guaranteed payment (Treas. Reg. section 1.736-1(a)(5)).

- Payments made under IRC section 736(a)(2) are deductible by the partnership (Treas. Reg. section 1.736-1(a)(4)); and,

- A payment under IRC section 736(a)(1) retains its character for purposes of determining the taxation of the recipient (IRC section 702(b)).

The characteristics of IRC section 736(b) payments are:

- Payments made in exchange for the partner's interest in partnership property are distributions;

- All payments to a retiring limited partner in a partnership in which capital is not a material income-producing factor and all payments to all partners in a partnership where capital is a material income-producing factor are IRC section 736(b) payments. Exception: payments for the partner's interest in unrealized receivables (IRC section 751(c) – depreciation recapture) which are in excess of the partnership's basis in such receivables are IRC section 736(a) payments (Treas. Reg. section 1.736-1(b)(2)).

- IRC section 736(b) payments do not include any amount paid for the partner's share of goodwill in excess of the partner's basis in the partnership interest; unless specifically provided for in the partnership agreement. (Treas. Reg. section 1.736-1(b)(3)).

- IRC section 736(b) payments are reported in the taxable year in which received, regardless of the departing partner's or the partnership's method of accounting (Treas. Reg. section 1.736-1(a)(5)).

- If an IRC section 754 election is in place, the partnership can receive a step-up in basis under IRC section 734(b) for the excess amounts paid for the retiring partner's interest in the partnership property.

The rules for the allocation of payments between IRC section 736(a) and IRC section 736(b) are contained in section 1.736-1(b)(5) of the Treasury Regulations.

If the payments are fixed in amount and made over a number of years, section 1.736-1(b)(6) of the Treasury Regulations allows the partner to elect to attribute an amount of gain to each installment payment instead of first recovering basis. Examples are provided in section 1.736-1(b)(7) of the Treasury Regulations.

The following points are made regarding the **death of a partner**:

- Death of the partner does not ordinarily result in the termination of the partnership under IRC section 708(b). Termination of a partnership interest by reason of death does not result in the closing of the partnership taxable year (IRC section 706(c)(1)).

- The taxable year of the partnership closes with respect to a partner whose interest in the partnership terminates by reason of death (IRC section 706(c)(2)(A)). This rule represents a change included in the Taxpayer Relief

Act of 1997 (TRA ’97) and is effective for partnership taxable years beginning after December 31, 1997.

- The amount includible in the gross income of a successor in interest of a deceased partner under IRC section 736(a) is considered income in respect of a decedent under IRC section 691 (IRC section 753).

Pre-TRA ‘97

- The decedent’s individual return closed as of the date of death (Treas. Reg. section 1.443-1(a)(2)). This does not mean that an individual files his Form 1040 for a period other than his normal calendar year. (See next item).

- The final return of a deceased partner does not include any partnership distributive items (income, loss, deductions and credits). IRC section 706(a) governed here because the death of the partner caused the partner's year to end earlier than that of the partnership.

- The deceased partner’s share of partnership distributive items was included in the return of the successor, even if income was distributed during that part of the year which pre-dated the partner’s death (IRC section 731(a)(1) and Treas. Reg. section 1.731-1(a)(1)(i)).

Post TRA ‘ 97

- TRA ’97, IRC section 1246(a), amended IRC section 706(c)(2) requiring that the partnership year close with respect to the deceased partner as of the date of death. As a result, the partner’s share of income, losses, deductions and credits are included in the partner’s final income tax return, as determined from the beginning of the partnership year to the date of the partner’s death.

- The person named in the partnership agreement as successor partner in the event of death is recognized as the successor for federal income tax purposes (Treas. Reg. section 1.706-1(c)(3)(ii)).

- A sale of the entire deceased partner’s partnership interest as of the date of death will not cause a partnership termination (IRC section 706(c)(2)(A)(i)). The decedent and the new partner must each include their proportionate share of partnership income, loss, deductions and credits.

- Transfer, upon death, of the partner’s interest in the partnership does not result in disposition gain. That is, no gain is attributed to the decedent even if the interest entails a share of partnership debt or unrealized receivables.

- No gain is recognized on the transfer to the decedent’s estate, or to a successor by bequest (IRC section 752(d), Treas. Reg. section 1.752-1 and ***Crane v. Commissioner***, 331 U.S 1 (1947)).

- Any suspended passive activity losses will be allowed on the decedent's final return. However, the suspended loss is reduced by the amount by which the basis of the partnership interest to the successor (stepped-up basis) exceeds the adjusted basis of the partnership interest to the decedent immediately before death (IRC section 469(g)(2)). **If, as a result of this provision, any part of the suspended passive activity loss is not allowed on the decedent's final return, it will not be allowed to anyone, ever (IRC section 469(g)(2)(B)).**

- The basis of the partnership interest to the successor is the FMV as of the date of death or alternate valuation date (IRC section 1014(a)), reduced by income in respect of a decedent and, increased by the successor's share of liabilities as of the date of death or alternate valuation date (Treas. Reg. section 1.742-1)). Refer to IRC section 691 for rules relating to income in respect of a decedent (IRD).

- The successor partner's basis in the partnership interest will be its FMV per IRC sections 742 and 1014. This may result in the successor having an outside basis in excess of the partnership's inside basis. If an IRC section 754 election is in place, the partnership can step-up the basis of assets under IRC section 743(b) solely for the benefit of the successor.

- If the IRC section 754 election is in place and the successor's outside basis is less than the partnership's inside basis, a step-down in basis will be required.

- A successor may continue as a partner.

- A successor may sell the partnership interest to the existing partners or a third party. See the "Sales and Exchanges" section of this chapter.

- A successor may have his partnership interest liquidated. See the discussion of IRC section 736, above.

Examination Techniques

Examination techniques and issue identification focus on post RRA '93, for transactions involving partners who retire or die on or after January 5, 1993.

Aside from the allocation of payments under IRC sections 736(a) and 736(b), payments made in retirement of a partner's interest or deceased partner's successor in interest bear numerous similarities to payments in complete liquidation of a partner's interest under IRC section 731.

IRC section 736 is designed to prevent tax avoidance by requiring the departing partner and the partnership to treat the payments consistently. This was reinforced by RRA '93 which requires that payments must be treated as made in exchange for the partner's interest in partnership property under IRC section 736(b) and not as a distributive share or guaranteed payment that gives rise to partnership deductions.

IRC section 736(b) payments must equal the fair market value of the terminating partner's share of partnership assets. This represents payment for the partnership interest. Identify unrealized receivables for potential ordinary income.

In addition to the fair market value of partnership assets, the taxpayers can allocate a **reasonable** amount to goodwill. **This amount must be specified in the partnership agreement.**

Any payments in excess of the IRC section 736(b) payments described above must be allocated to IRC section 736(a) payments.

Apply new IRC section 736(b)(3), in cases where the allocation of payments does not comply with the new provisions under RRA '93.

In terms of properly applying the new rules under RRA '93, determine whether capital is or is not a material income-producing factor.

In terms of the decedent and the successor, a determination should be made regarding the allocation of distributive partnership items (pre- versus post TRA '97). Also, determine if there has been a proper step-up or step-down basis adjustment.

To the extent that IRC sections 469(g)(2) and 469(g)(2)(B) are applicable, make sure that neither the decedent nor the successor have claimed a deduction for suspended passive activity losses.

Issue Identification

The underlying inducement for unreasonable allocations between IRC section 736(a) and IRC section 736(b) payments may be the disparity of current tax rates for ordinary income and capital gains. The issues to be raised will revolve around the proper character of the payments, as well as the allocation between IRC sections 736(a) and 736(b).

Items that represent payments for the departing partner's FMV of partnership property should be classified as an IRC section 736(b) payment. Items that are specifically identified by statute as being in the nature of an IRC section 736(a) payment should be classified as an IRC section 736(a) payment. Items over which the partnership and partner have discretionary authority for determining how payments will be allocated will require a determination as to reasonableness.

Knowing the tax position of the departing partner, as well as significant remaining partners, is advantageous from the standpoint of identifying a motive for the agreed upon treatment and allocation.

Does the departing partner have a large and otherwise unused capital loss? Do the remaining partners have net operating losses or are they in low tax brackets for the year? In this scenario, the purported allocation may be in favor of IRC section

736(b). If the departing partner has a large or expiring net operating loss and the remaining partners are in a high tax bracket for the year, the shift may be in favor IRC section 736(a).

The treatment of IRC section 752(b) – decrease in a partner's share of liabilities, as a constructive receipt of cash, applies in calculating the amount of payments received. Identification of this issue was covered in other parts of this chapter.

Substance versus form: as in the section on liquidation of a partner's interest, look for any indication that might serve to characterize the transaction as a sale despite any precautions by the parties to cast it differently. Remember, among other differences, liquidating payments do not result in gain to the partner except to the extent they exceed his basis, while a sale over a period of time will require an apportionment of gain to the yearly payments received.

On partnership returns with a departing partner, look for a reduction to goodwill on the balance sheet and guaranteed payments on the departing partner's Schedule K-1.

Watch for a Notice of Inconsistent Treatment, Form 8082, (TEFRA partners) or Disclosure Statement, Form 8275, (non-TEFRA partners) that refers to IRC section 736. This may be an indication that the retiring partner is allocating retirement payments between IRC sections 736(a) and 736(b) in a manner differing from that of the partnership or other partners.

Documents to Request

1. Partnership agreement
2. Property fair market value determinations
3. Copy of departing partner's return
4. Copy of the remaining partners' returns (or at least those with the greater participation)
5. If necessary, substitute RTVUE/BRTVUE or MACS print
6. Partnership 736(a) and 736(b) allocation worksheet

Interview Questions

1. Question any allocations which seem misclassified or unreasonable.

2. Question FMV determinations which do not appear to be economically grounded (over or undervalued).

3. Question the FMV placed on major assets of the partnership. Submit valuation referral, if required.

4. Question any sign that the departing partner has been relieved of debt but has not properly treated the relief under IRC section 752(b).

5. Question the extent to which the retiring partner is severed from the partnership (complete liquidation required).

Supporting Law

IRC, Subchapter K: Section 704
Section 706(a)
Section 707(c)
Section 708(b)
Section 731-736
Section 751
Section 752(b) & (c)
Section 753 - 755

IRC section 443
IRC section 469
IRC section 691
IRC section 1014
Supporting regulations and specific regulations cited above.

Revenue Reconciliation Act of 1993 (RRA '93)
Taxpayer Relief Act of 1997 (TRA '97)

The issue of allocating all or most of the payments to IRC section 736(a) has not been litigated. This is likely attributable to the relative newness of the changes brought about by RRA '93. There have been several cases litigated on the absence of a provision in the partnership agreement stipulating that distribution in liquidation of a partnership interest includes payments for goodwill.

See cases cited in the section of this chapter covering liquidations.

Crane v. Commissioner, 331 U.S. 1 (1947)
No gain is recognized on the transfer of property to the decedent's estate, or to a successor by bequest.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

BNA, Tax Management Portfolio, Vol. 716

Gunn, Federal Tax Problems of Income in Respect of a Deceased Partner, 3 J. P'ship Tax'n 23 (Spring 1986)

Tousey & Wallis, Liquidation of a Partnership Interest of a Deceased Partner, 10 J. P'ship Tax'n 272 (Fall 1993)

Yuhas & Fellows, Gain on Partnership Interest Is Now More Likely to Be Ordinary, 52 Tax'n for Accts 146 (March 1994)

Carmen & Dance, New Provisions of RRA'93 Will Have a Major Impact on Partnerships and Partners, 11 J. P'ship Tax'n 3 (Spring 1994)

Partnership Industry Program, Significant Issues Alert, "Payments to a Retiring Partner"

2 William S. McKee, William F. Nelson & Robert L. Whitmire, Federal Taxation of Partnerships and Partners, Part VII, Death or Retirement of a Partner (3d ed. 1997).

Steven C. Thompson, Partnership Taxation – Advanced, Englewood, CO; MicroMash, Chapter 7, Special Problems of Retiring and Deceased Partners

ISSUE: GIFT OR CONTRIBUTION OF A PARTNERSHIP INTEREST

The gifting of a partnership interest and the contribution of a partnership interest to a charitable organization can result in the recognition of income to the donor. This section covers both transactions.

Gifting of a Partnership Interest

The gifting of an interest in a partnership is usually a family affair. IRC section 704(e)(3) concludes that the purchase of a partnership interest in a family partnership by one member of a family from another shall be considered to be created by a gift from the seller. IRC section 704(e)(2) addresses the allocation of distributive share where the partnership interest is created by gift. Refer to Chapter 11, Family Partnerships, for an understanding of transactions between family members. Of course, the gifting of a partnership interest to a family member can be other than an interest in a family partnership.

The gifting of a partnership interest involves the consideration and determination of several factors which may have a tax effect for the donor:

- Fair market value of the partnership interest
- Adjusted basis of the partnership interest
- Allocation of distributive share (donor/donee)
- Debt relief to the donor
- Gain on a deemed sale as a result of debt relief
- Ordinary income versus capital gain on the deemed sale

- The allowance of suspended passive activity losses

- Gift tax

The gifting of a partnership interest which is free of liabilities (that is, the partnership has no liabilities or the donor has no share of partnership liabilities under IRC section 752) would not be subject to income taxes. If the partnership interest is encumbered by debt, or the donor partner shares in partnership liabilities pursuant to IRC section 752, there is a taxable event.

Gifts of a Partnership Interest Encumbered by Debt

Basis of the gift in the hands of the donee when the partnership interest is encumbered by debt:

- The unadjusted basis to the donee is the greater of the amount "paid" by the transferee, which is the debt assumed by the donee in the instance where it exceeded the transferor's adjusted basis at the time of the gift, or the transferor's adjusted basis at the time of the gift.

- After making the above calculation, apply the general rules of IRC section 1015.

When the partnership interest, which is encumbered by debt, is transferred to a donee who accepts the gifted interest subject to the debt and thereby assumes the liability of the donor, a taxable event occurs. Either IRC section 752(b) or IRC section 752(d) apply in the instance of a gifted partnership interest.

When there is a taxable gain to be considered, the gift of the partnership interest is split into two parts, one part gift and the other part sale. Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him (the debt relief) exceeds his or her adjusted basis in the property. However, no loss is sustained in such a transfer if the amount realized is less than the adjusted basis (Treas. Reg. section 1.1001-1(e)(1)). Section 1.1001-1(e)(2) of the Treasury Regulations provides an assortment of examples. Refer to the discussion of **bargain sales** which appears later in this section.

While the above gain is capital gain, some of it may have to be classified as ordinary income if there are IRC section 751 assets involved. If the partnership interest included depreciable assets that were subject to depreciation recapture (an IRC section 751(c) asset), the recapture amount would be ordinary income.

The basis of the partnership interest to the recipient (donee) is determined with reference to the general guidelines of IRC section 1015, Basis of property acquired by gifts and transfers in trust.

Gifts of a Partnership Interest Not Encumbered by Debt

Basis of the gift in the hands of the donee when the partnership interest is not encumbered by debt:

- Basis for the purpose of determining future gain, would be the same as in the hands of the donor; the donor's adjusted basis.

- Basis, for the purpose of determining future loss, would be the same as for determining gain except that if the donor's adjusted basis is greater than the fair market value of the property at the time of the gift, the basis to the donee is the fair market value at the time of the gift.

Effect on Passive Losses

The gifting of a partnership interest, with respect to which there are accumulated suspended passive activity losses, will not trigger an allowance of the losses to the donor. The total of the suspended passive activity losses are instead added to the adjusted basis of the partnership interest (IRC section 469(j)(6)(A)) and thus will affect the basis of the donee. The suspended passive activity losses are not allowable as a deduction for any taxable year (IRC section 469(j)(6)(B)).

The suspended passive activity loss carryover will produce a step-up in basis that would not otherwise be available for a gifted partnership interest as IRC section 743(b) does not apply to gratuitous transfers. Any tax benefits to the donee are deferred until such time as the interest is disposed of in a taxable transaction.

If this "bloated" basis exceeds the FMV of the partnership interest at the time of the gift, and the donee subsequently disposes of the interest in a taxable transaction resulting in a loss, no loss is allowable. The PAL carryover can reduce gain but it cannot create a loss.

Gift tax is calculated on the amount by which the FMV of the gifted property exceeds the debt relief to the donor. It should be noted that the gift tax paid serves to increase the basis (IRC section 1015(d)). If the gift tax is paid by the donee, the donor must realize taxable income (see ***Diedrich v. Commissioner*** in the Supporting Law section).

Contribution of a Partnership Interest to a Charitable Organization

A partner may contribute a partnership interest to a charitable organization. When that partnership interest is encumbered by debt or the partnership interest includes IRC section 751 assets, the donor will be required to recognize income, even though the partner is giving the interest away to charity.

- How do you compute the amount of the charitable contribution?

- How can the partner have a gain when making a charitable contribution?

Before you can determine the amount of the allowable deduction for the charitable contribution of property, you must determine if the property is ordinary income property or capital gain property. Any ordinary income portion will reduce the charitable contribution, under IRC section 170. If the property is ordinary income property the amount that can be deducted as a contribution is its fair market value, less the amount that would be recognized as ordinary income. This generally limits the contribution deduction to the basis in the property. Examples of ordinary income include inventory, capital assets held less than a year, and the portion of depreciation recapture on depreciable business property that would be treated as ordinary income if the property were sold at its fair market value at the time of the contribution.

If the property is capital gain property, the amount that can be deducted as a charitable contribution is its fair market value. Certain adjustments are required if the property (other than qualified stock) is; (a) given to certain private non-operating foundations, (b) put to an unrelated use by the charity, or (c) the 50 percent limitation is used.

When a partner **contributes** his or her partnership interest to a charitable organization, he or she receives a charitable contribution deduction for the amount by which the fair market value of the partnership interest exceeds any relief of debt. The amount of the debt relief is considered the amount realized from a **bargain sale**.

- IRC section 752(b) treats the partner's decrease in his or her share of liabilities, as a deemed distribution of cash to the partner. Therefore, when the interest is donated to the charitable organization, any balance of debt allocable to the donating partner is deemed to be a cash distribution and is then properly included in the amount realized on the bargain sale.

- IRC section 752(d) treats the decrease in the partner's share of partnership liabilities as part of the amount realized in much the same way as IRC section 752(b) treats it as a deemed distribution. Again, any balance of debt allocable to the donating partner at the time of the contribution is included in the amount realized on the bargain sale.

This creates the situation where, even though the donating partner receives no cash or other assets, he or she is deemed to have received cash/compensation for that part of his or her partnership interest which is determined to be encumbered by debt, under the bargain sale computation.

IRC section 1011(b) provides that the donor's basis be prorated between the portion deemed contributed and the portion deemed sold. The equation for the proration under IRC section 1011(b) is the amount realized from the debt relief divided by the FMV times the total basis equals the portion of basis allocable to the portion deemed sold. If IRC section 751(c) assets are involved, the gain may be part ordinary and part capital. Sections 1.1011-2(c) and 1.170A-4(d) of the Treasury Regulations provide several examples. Also, see Example 3 below.

If the amount of the debt relief exceeds the fair market value of the partnership interest being contributed, bargain sale rules will not apply. The amount realized will be the amount of the debt relief and the difference between this amount and the partner's adjusted basis in the partnership interest is the amount of the gain on disposition. Since the FMV of the partnership interest is less than the debt by which it is encumbered, the partner has no equity in the partnership interest and should receive no charitable deduction.

The contribution of a partnership interest to a charitable organization, on which there is accumulated suspended passive activity losses, will not trigger an allowance of the loss to the donor. The donor may **never** deduct the accumulated passive activity losses in such a situation. The suspended PAL is added to the donor's basis at the time the partnership interest is contributed. If there is any tax benefit to be gained, it will be through a larger basis offset in a bargain sale calculation.

Example 3

On December 31, 1999, D, an individual, contributes his partnership interest in XYZ, a general partnership, to a recognized charitable organization under IRC section 170(c). At the time of the contribution the fair market value of D's interest is $50,000. The partnership contains no assets that would generate ordinary income if sold. D has held his partnership interest for more than one year. His basis is $40,000 computed as follows:

Cash invested	50,000
Annual Adjustments, Sections 705 & 752	(40,000)
Share of Liabilities	30,000
Adjusted Basis	40,000

Per IRC section 752(d), the reduction in liabilities due to the disposition of the partnership interest is $30,000. Therefore, the bargain sale amount realized is $30,000.

		Sale	Gift	
Amount realized		30,000	0	Section 752(d)
Allocate basis	(1)	24,000	16,000	Section 1011(b)
Gain	(3)	6,000	N/A	
Contribution Amount (2)			20,000	

(1) Allocation: $\frac{\text{Amount Realized}}{\text{Fair Market Value}} \times \text{Basis}$

(30,000/50000) X 40,000 = 24,000

(2) The contribution amount per IRC section 170 is equal to the fair market value of the portion donated. Note however, that if there were any ordinary income assets (IRC section 751) in the

partnership (and there generally is) the gift must be reduced under Treas. Reg. section 1.170A-4(c)(3).

(3) Likewise, in this example, the gain is capital gain. However, if any portion of the partnership interest were considered an ordinary income asset under IRC section 751, the gain would have to be allocated between ordinary and capital.

Examination Techniques

Since the gifting of a partnership interest typically takes place in the context of the family unit, as defined by statute, refer to Chapter 11, "Family Partnerships," and other available sources.

The contribution of a partnership interest should be viewed in terms of the FMV determination, with consideration given to bargain sales, and the rules contained in IRC section 170. Contributions to a private charitable foundation should be scrutinized for the degree to which control of the interest has been relinquished, as well as other issues inherent in contributions of this type. Related issues may be developed under IRC sections 501(c) and 507 - 509. If necessary, seek the assistance of Exempt Organization.

- Obtain the facts regarding the donation. To whom, when, FMV determination, etc.
- Determine if the donation is allowable under IRC section 170 as a charitable contribution, if not, IRC section 1011(b) is not applicable.
- Verify the partner's basis in the partnership.
- Determine the partner's share of debt, if any.
- Determine if the partner has been relieved of debt as a consequence of donating the property. Apply the bargain sales rule, if warranted.
- Determine the ordinary income portion attributable to the donated interest.
- Allocate the sale portion between ordinary and capital.
- After bargain sale consideration, determine the amount allowable as a contribution.

As with any type of disposition that represents a final disposition of a partnership interest, the examiner should investigate how the partner has treated any accumulated passive activity losses.

Issue Identification

For purposes of a gift or charitable contribution, issue identification will involve determining the presence of debt associated with the partnership interest and the underlying IRC section 751 assets.

The issue of fair market value of the partnership interest, if significant, may be a matter for referral.

The initial indication that a partner has contributed his or her partnership interest should be evident from the appearance of a contribution deduction on the partner's return. In the instance of a gift or contribution of a partnership interest, the partnership return will contain corresponding changes to item J of the Schedule K-1 for the gifting/contributing partner and the donee/charity. This may include increases to existing partners or the addition of new partners. Also, the donor's Schedule K-1 may be checked as final.

The likelihood that the donor partner may not have considered the gain from making the gift or gain on the bargain sale will be evidenced by the absence of the transaction on the partner's Schedule D.

If the partner is a limited partner, look for passive activity loss adjustments. The former partner should not be allowed to claim a deduction for accumulated PAL.

If the partnership agreement prohibits the contribution or gifting of a partnership interest, the departing partner may be treated as having abandoned the partnership interest, which may qualify as a sale. Refer to the section on "Abandonment of a Partnership Interest".

Where there is a gift of a partnership interest with a negative capital account, it will be encumbered by debt and, therefore, the bargain sale rules will always be implicated.

Documents to Request

The following assumes the issue of gift or contribution of the partnership interest is identified at the partnership level.

1. Partnership agreement
2. Prior and subsequent year partnership tax returns
3. Review any Form 8308. It is required to be filed when a partnership interest is transferred and the partnership has IRC section 751 assets.
4. Calculation of the donor partner's basis
5. Documents concerning FMV determination
6. Transfer agreement between the donor and the donee, including any provisions for debt assumption
7. Donor partner's tax return for the year at issue
8. Copy of donee's return
9. Partner's bargain sale calculation including calculation for built-in depreciation recapture and other IRC section 751 considerations
10. Copy of Gift Tax return(s) filed

Interview Questions

1. What was donated and to whom?
2. How was the partnership interest valued? FMV?
3. Question the relationship between the donor and donee.
4. What happened to the donor partner's share of liabilities?

5. Was the donor partner liable for recourse debt? Did the partner remain liable for the debt after donating the partnership interest?
6. Question factors inherent in a contribution made to a private foundation or secure enough information for a referral to Exempt Organization, if necessary.
7. Question the FMV of the donated partnership interest, if necessary, and all other calculations.

Supporting Law

IRC, Subchapter K: Section 704
Section 705
Section 731
Section 751
Section 752
IRC section 170
IRC section 469
IRC section 501(c)
IRC section 507 – 509
IRC section 1001
IRC section 1011
IRC section 1015
Supporting regulations and specific regulations cited above.

Revenue Ruling 75-194
The donation of a partner's interest in a limited partnership to a charitable organization was deductible after reductions required by IRC section 170(e)(1). The FMV of the donating partner's share of partnership assets exceeded his or her share of partnership liabilities thereby creating a charitable contribution deduction under IRC section 170. However, at the time of the contribution, the amount of the contributing partner's share of partnership liabilities should be treated as an amount realized by the partner in a bargain sale transaction. The contribution results in both a gain from a bargain sale and a charitable contribution deduction.

This ruling has been codified as Treas. Reg.section 1.1011-2(c), example 4.

***Diedrich v. Commissioner*, 457 U.S. 191 (1982), *aff'g* 643 F.2d 499 (8th Cir. 1981), *Rev'g* T.C. Memo 1979-441.**
The Supreme Court affirmed the determination of the Court of Appeals for the 8th Circuit. The donor of a gift realized taxable income to the extent that the gift taxes paid by the donee exceeded the donor's adjusted basis in the property. The court deemed this to be consistent with IRC section 1001. "The fact that the gift tax obligation was discharged by way of a conditional gift rather than from funds derived from a pre-gift sale did not alter the benefit to the donor."

Although the property in this case was corporate stock rather than a partnership interest, the result should not differ in the case of a partnership interest or LLC membership interest.

***Maxine Goodman, et al., v. United States*, 2000-1, U.S.T.C. (1999)**
The U.S. District Court for the Southern District of Florida decided that IRC section 752(d) and IRC section 1011(b) required an individual to treat as a bargain sale the contribution of a partnership interest to a charitable organization. The taxpayer's argument that IRC section 1011(b) only applies to sales, and not to gifts, was rejected.

Revenue Ruling 75-194 was a supporting document to the court's determination.

Resources

RIA U.S. Tax Reporter - Income Taxes

CCH Standard Federal Tax Reporter

BNA, Tax Management Portfolio, Vol. 718

McKee, William S., Nelson, William F., and Whitmire, Robert L. Federal Taxation of Partnerships and Partners, Boston, MA; Warren, Gorham & Lamont, Publisher. Part V, Chapter 15.05: Gratuitous Transfers of Partnership Interests.

ISSUE: ABANDONMENT OF A PARTNERSHIP INTEREST

There are three methods by which a partner can **surrender** a partnership interest: **forfeiture, abandonment, or worthlessness.**

The partnership agreement may contain a set of specifications whereby the partnership will consider the partner to have forfeited the partnership interest. This may include, but is not limited to, failure to keep up with payments under the subscription agreement. Forfeiture of a partnership interest can have the same consequences as abandonment, which this section covers in detail.

The recognition of a partner's ability to consider his or her partnership interest worthless relies heavily on timing and the measure by which a partnership is determined to be worthless in a **closed and completed transaction**. Worthlessness is often an effect of hopeless insolvency. Walking away from the partnership in this manner will cast the transaction as a sale resulting in capital loss. See ***Echols v. Commissioner***, 935 F.2d 703 (5th Cir. 1991), for a comprehensive discussion on worthlessness of a partnership interest.

Abandonment affords a partner the opportunity to derive ordinary loss from what is generally considered a capital asset - the partnership interest. Abandonment of an asset occurs when a taxpayer abandons property and receives **nothing** in return. Abandonment of a partnership interest will be characterized as an ordinary loss under the general rule of IRC section 165(a) which states that "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise".

An understanding of the facts, conditions and circumstances present at the time of the abandonment is crucial in determining whether the actions of the partner constitute abandonment or sale of the partnership interest.

There is no definitive way to abandon a partnership interest. Neither the Code sections nor the regulations provide guidance as to a procedure for abandonment. It is generally accepted that there must be some overt action on the part of the partner that can be construed as an attempt to make clear to the partnership, general partner and other involved third parties, the intent to surrender the partnership interest.

Once it is established that the partner abandoned the partnership interest, the issue of a closed and completed transaction must be settled. Section 1.165-1(b) of the Treasury Regulations states that, in order to be allowed, the loss must be evidenced by a closed and completed transaction, fixed by identifiable events and actually sustained during the year. In the instance of a qualified abandonment, the partner has surrendered all legal rights to the partnership interest with the expectation of receiving nothing in return. Under these conditions, the very act of abandonment, absent any related matter that may continue to bind the partner to the partnership, should satisfy the closed and completed transaction requirement.

Characterizing the loss as either ordinary or capital is contingent on the various attributes of the partnership interest. Generally, a partner who abandons a partnership interest, **with no debt allocation**, will be afforded ordinary loss treatment under IRC section 165(a). However, a partner whose partnership interest includes an allocation of debt for which he or she does not remain liable will be deemed to have received a distribution (IRC section 752(b)) upon surrendering his or her interest in the partnership and the transaction will be viewed as a sale of a capital asset.

The presence of accrued liabilities for which the partnership reduced distributive income to the partner would give rise to a deemed distribution and thus be treated as a sale.

The courts have ruled that even a de minimus amount determined in any way to be compensation for the partnership interest will cast the transaction as a sale.

The amount of loss is calculated as the total of the abandoning partner's unrecovered basis. The abandonment may even result in gain if the partner had a deficit capital account at the time of the abandonment.

At the time of the abandonment, the partnership may be holding IRC section 751 assets. If the abandonment is treated as a sale, and the partnership holds IRC section 751 assets, the amount realized would not be derived exclusively from the sale of a capital asset.

Finally, keep in mind that losses allowed under IRC section 165(a) are limited for individuals by IRC section 165(c)(1) to losses incurred in a trade or business; or

losses incurred in any transaction entered into for profit, though not connected with a trade or business, as stated in IRC section 165(c)(2).

Examination Techniques

The examination techniques used should serve, in the end, to answer the following:

- Do the underlying partnership transactions have **economic substance**? The issue regarding the determination of economic substance, or lack thereof, is not a matter for discussion in this chapter. Refer to Chapter 9.

- Was the partnership interest abandoned (in a closed and completed transaction)?

- Was the abandoning partner relieved of his or her share of partnership debt?

- Was the abandoning partner, in any way, compensated for his or her partnership interest?

- Was the gain or loss properly calculated?

Issue Identification

The issue of abandonment can be identified on either the partner's individual tax return or the partnership return. The partner should be expected to report the transaction on Schedule D or E, depending on how the transaction has been treated (capital v. ordinary). If the activity was passive, the balance of carryover passive activity losses from this particular entity will be deducted in full under IRC section 469(g)(1) and Treas. Reg. section 1.469-2T(d)(5).

The partnership return may not actually spell out the fact that the interest has been abandoned. At a minimum, a screening of a partner Schedule K-1, item J, Analysis of Partner's Capital Account, can reveal that a partner's capital account has been cancelled. Review the prior year's Schedule K-1 for the partner in question. Did item F, Partner's Share of Liabilities, contain an allocation of partnership debt? If so, then compare it to the current year's entry in item F. If the partner's final Schedule K-1 still reports non-recourse debt in item F, determine why it has not been reallocated among the remaining partners. If the partner's final Schedule K-1 reports recourse debt, does his or her liability extend beyond participation in the partnership? Any reallocation from non-recourse to recourse debt allocable to the departing partner should be questioned, since it may have been intended to eliminate a deemed sale.

Also consider the step transaction doctrine whereby certain transactions executed by the partnership, in anticipation of the abandonment, may have cleared the path for treating the loss as ordinary instead of capital. The issue here is one of substance versus form. (Rev. Rul. 93-80).

Compare the balance sheet for the year under examination with that of the subsequent year. Has the correct amount of debt been retained by the partnership? The balance sheet should also be screened for the presence of IRC section 751 assets at the time of abandonment.

Review Schedule M-2 for the reconciliation of capital accounts in the absence of the departing partner.

Flip through the Schedules K-1 contained in the partnership tax return for the year subsequent to the alleged abandonment. The inclusion of a Schedule K-1 for the "abandoning" partner is evidence that the partnership and other partners continue to treat the taxpayer as a partner. The preparation of a Schedule K-1, along with a failure to recognize the abandonment by amendment to the partnership agreement, should raise doubts as to whether any alleged, recognizable, manifestation or overt conveyance of intent to abandon occurred or existed and should be grounds for denial of the abandonment loss.

Generation of the Schedule K-1 may have been caused by a breakdown in communication between the partnership and the return preparer. How did this partner treat the receipt of the Schedule K-1? Did he or she file a Form 8082 as a Notice of Inconsistent Treatment (TEFRA partners only) or a Form 8275, Disclosure Statement, (Non-TEFRA partners) or was receipt of the Schedule K-1 ignored?

If the issue is worthlessness of a partnership interest, how have the other partners treated their partnership interest? If the facts relevant to worthlessness are the same for all partners in the partnership, a claim of worthlessness by just one partner is suspect and may constitute a whipsaw issue. If, on the other hand, the examining agent determines that all partnership interests are worthless, consider whether the partnership return gives the appearance of being a "zombie". If a "zombie" partnership issue is to be developed, contact the Partnership Technical Advisor.

Documents to Request

1. Partnership agreement
2. Prior and subsequent year partnership tax returns
3. Correspondence submitted by the abandoning partner to the partnership in which the expression of abandonment is set forth.
4. Copy of partnership response, if any.
5. Debt instruments

Interview Questions

1. Is there a provision in the partnership agreement that provides a means by which a partner can abandon his or her partnership interest or will be deemed to have forfeited his or her partnership interest?

2. Was the departing partner allocated a share of partnership debt?

3. Was the debt recourse or non-recourse or both?

4. How was the departing partner's allocation of unsatisfied debt treated by the partnership upon departure of the partner?

5. Was the departing partner compensated for his partnership interest by the partnership or any of its partners?

6. At the time of abandonment, did the departing partner have any claims against the partnership or any of its partners in respect of his partnership interest?

Supporting Law

IRC, Subchapter K: Section 705
Section 731
Section 741
Section 751
Section 752
IRC section 165
Supporting regulation and specific regulations cited above.

Revenue Ruling 93-80
A loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply. If there is an actual or deemed distribution to the partner, or if the transaction is otherwise in substance a sale or exchange, the partner's loss is capital (except as provided in section 751(b) of the Code).

For purposes of determining whether or not IRC section 752(b) applies to create a deemed distribution upon abandonment or worthlessness, liability shifts that take place in anticipation of such event are treated as occurring at the time of the abandonment or worthlessness under general tax principles.

***Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *Rev'g* 93 T.C. 553 (1989)**
The Court of Appeals for the Fifth Circuit, in overruling a decision of the Tax Court, discussed the application of the worthlessness and abandonment doctrines. The court characterized the determination of worthlessness as having both objective and subjective elements.

***Citron v. Commissioner*, 97 T.C. 200 (1991)**
The Tax Court ruled that the partner had abandoned his interest and, in the absence of partnership liabilities, the loss on abandonment was an ordinary loss under IRC section 165(a).

***O'Brien v. Commissioner*, 77 T.C. 113 (1981); *Aff'd per cu.* 693 F.2d 124 (CA–11, 1982)**
The Tax Court ruled that the decrease in a taxpayer's individual liabilities by reason of the partnership's assumption of debt could be a deemed distribution under IRC section 752(b). The deemed distribution, in turn, gives rise to a sale or exchange under IRC section 731(a), resulting in capital loss under IRC section 741.

***La Rue v. Commissioner*, 90 T.C. 465 (1988)**
The Tax Court stated that the touchstone for sale or exchange treatment is consideration. If in return for assets, any consideration is received, even if nominal, the transaction will be classified as a sale or exchange.

***Wright v. Commissioner*, T.C. Memo 1994-288**
The taxpayers conceded that they were not entitled to flow-through losses, deductions or credits from the partnership, however, they argued in favor of claiming a loss based on the purported worthlessness of their interest in the same partnership. The Tax Court found that the taxpayers were not liable for penalties under IRC sections 6653 (negligence) and 6661 (substantial understatement) due to what the court viewed as their good faith intentions in making an investment motivated by profit objectives. The court ruled that, notwithstanding the taxpayers' subjective intent of making a profit, the investment will not be recognized for tax purposes if the overall transaction lacks economic substance and business purpose.

***Marinovich v. Commissioner*, T.C. Memo 1999-179**
In a case similar to ***Wright v. Commissioner***, the Tax Court ruled that even if taxpayers invested in the partnerships with the individual objective of making a profit, taxpayers are not entitled to deduct out-of- pocket cash invested in the partnerships as losses under IRC section 165(c)(2) if the partnership transactions lack economic substance.

Resources

RIA U.S. Tax Reporter – Income Taxes

CCH Standard Federal Tax Reporter

Kevin N. Kemp et al., 718 Tax Mgmt., Dispositions of Partnership Interests - Termination of a Partnership

Williford, New Ruling Clarifies the Tax Consequences of Abandoning a Partnership Interest, 52 J. P'hip Tax'n 39 (Spring 1994)

Liveson, Loss On Abandonment of Partnership May Be Ordinary, 52 Tax'n for Accts 132 (March 1994)

Kramer & Kramer, "Withdrawal From a Partnership After CITRON and ECHOLS" 24 Tax Advisors 386 (June 1993)

Pusker, Losses on Partnership Interests May Be Ordinary, 51 Tax'n for Accts 78 (August 1993)

Chapter 8

Real Estate Issues in Partnerships

INTRODUCTION

Approximately 50 percent of all partnerships are involved in the real estate business. A partnership may be involved in real estate development, construction, or leasing. Even though a partnership may not be involved in a real estate business it may own or lease real estate. This chapter covers various tax issues related to real estate such as:

- Cancellation of Indebtedness
- Tufts/ Non-recourse Debt and Unpaid Interest
- Accrued Contingent Interest
- Bankruptcy
- Low Income Housing Tax Credit
- Zombie Partnerships
- Uniform Capitalization ─ IRC section 263A

The first two issues deal with the determination of whether the reduction of partnership debt should be treated as taxable cancellation of indebtedness income under IRC section 61(a)(12). Cancellation of indebtedness income may not be taxable due to an exception under IRC section 108, or it may be considered a taxable gain from the sale/exchange of property under IRC section 61(a)(3). See decision chart (Exhibit 8-1) at the end of this chapter as an audit aid to assist you in making this determination.

ISSUE: CANCELLATION OF INDEBTEDNESS ─ IRC SECTIONS 108 AND 1017

When a partnership purchases real estate it normally finances a portion of the purchase price. Partnerships may refinance or restructure the debt due to financial difficulties, to get a lower interest rate, or borrow more money. If the partnership refinances or restructures the debt and part or all of the debt is discharged, the partnership will realize cancellation of indebtedness (COD) income. If a financially troubled partnership's property is sold at a foreclosure sale or to a third party, the partnership abandons property (such as by quit claim deed or a tax sale), or the partnership reconveys the property to the lender (that is, deed in lieu of foreclosure), it may realize COD income or realize a gain or loss on the disposition, or a combination of both. This determination will turn on the nature of the debt involved, that is, non-recourse or recourse, see Chapters 3 and 6 for additional information on recourse versus. non-recourse liabilities.

The determination of the existence or amount of COD income and the amount of sale/exchange gain or loss are both made at the partnership level.

If debt is discharged and the payment of the debt would have given the taxpayer a deduction, then the taxpayer does not realize COD income under IRC section 108(e)(2). For example, when a cash basis taxpayer's obligation to pay an expense is cancelled.

If seller financed debt is reduced for a solvent taxpayer, the reduction is treated as a purchase price reduction. It is not considered COD income. IRC section 108 (e)(5).

Each partner's distributive share of COD income and sale or exchange gain is separately stated on his or her Schedule K-1.

Partners must include COD income in taxable income unless an exception applies (IRC section 61(a)(12)). The taxability of COD income is determined at the partner level (IRC sections 108(d)(6) and 6231(a)(5)). In addition to the summary report an affected item report must be prepared because additional factual determinations are required at the partner level.

A partner may exclude COD income under IRC section 108 if:

1. Partner is bankrupt (Title 11 discharge-See sub-chapter B)
2. Partner is insolvent (limited to level of insolvency)
3. Qualified farm indebtedness is cancelled
4. Debt is Qualified Real Property Business Indebtedness ("QRPBI"), the partner is not a C corporation, and the partner elects to reduce basis in depreciable real property.

   Note: If more than one of these exceptions apply, they are applied in the above order. IRC section 108(a)(2)(A).

Non-Recourse Debt

Property Dispositions: (that is, Foreclosures, Abandonments, Sales, etc.)

COD income is not realized when property that secures non-recourse debt is disposed/sold (that is, sale, foreclosure, deed-in-lieu of foreclosure, abandonment, etc.). The non-recourse obligation is considered the amount realized (that is, sales proceeds) (***Tufts v. Commissioner***, 461 U.S. 300 and IRC section 7701(g)). It does not matter that the fair market value is equal to or less than the amount of the debt.

Example 8-1

Facts:	
Sales Price of Property	$200,000
Adjusted Basis	50,000
Non-recourse Liability	300,000

Computation of Gain:	
Amount Realized (Non-recourse Debt)	$300,000
Adjusted Basis	(50,000)
Gain on sale/exchange	$250,000

Property Retained-Debt Reduced

If the debtor retains the property and the creditor reduces non-recourse debt, COD income will be realized (***Gershkowitz v. Commissioner***, 88 T.C.984 (1987) and Rev. Rul. 91-31)

Example 8-2

Non-recourse debt before cancellation	$300,000
Non-recourse debt after cancellation	(200,000)
COD income (IRC section 61(a)(12))	$100,000

Property Sold and Debt Discharged

The following sequence of events are considered part of one overall sales transaction:

1. Partnership sells a building subject to non-recourse debt to a third party.
2. The sales proceeds go to the lender.
3. The lender discharges the difference between the debt and the sales proceeds.
4. The lender settles a partner's personal guarantee for a lesser amount.

In this transaction, the amount realized will equal the amount of the non-recourse debt less the amount required to be paid by the guarantor. (***2925 Briarpark, Ltd.***, TC Memo 1997-298, ***aff'd*** 99-1, Par. 50,209, (5th Cir.)

Recourse Debt

Property Dispositions

COD income may be realized when property that is security for recourse debt is disposed/sold. If recourse debt cancelled is more than the FMV/sales price of the property, the difference is treated as COD income. If recourse debt is equal or less than the FMV/sales price of the property, no COD income is realized. The difference between the FMV/sales price and adjusted basis of the property will be treated as gain or loss on sale/disposition of property (IRC section 1001(a)).

Example 8-3

Facts:			
Partnership owns a building with:			Computation:
FMV -	$100	Debt Owed	$200
Recourse Debt -	$200	FMV	(100)
Adjusted Basis	$ 75	COD Income	$100

FMV/Amount	
Realized	$100
Adjusted Basis	(75)
Gain-Taxable	$ 25

Property Retained-Debt Reduced

If the debtor retains the property and the creditor reduces recourse debt, COD income will be realized.

Example 8-4

Recourse debt before cancellation	$300,000
Recourse debt after cancellation	(200,000)
COD income (IRC section § 61(a)(12))	$100,000

Exceptions

Bankruptcy

See Issue D in this chapter.

Insolvency

If a partner is insolvent, then he or she may exclude COD income to the extent insolvent (IRC section 108(a)(1)(B) and IRC section 108(a)(3). If the cancellation of debt removes a partner from insolvency, the partner must recognize income to the extent made solvent. That is, to the extent the fair market value of the partner's assets exceeds his or her liabilities immediately after the cancellation.

Insolvency is determined immediately before discharge of debt (IRC section 108(d)(3)).

The amount by which a non-recourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent, but only to the extent that the excess non-recourse debt is discharged. Rev. Rul. 92-53.

The fair market value of assets that are exempt under state law are not excludable in determining insolvency.

Contingent liabilities (guarantees) are not included in the insolvency computation. ***Merkel***, 109 T.C. 463 (1997), ***aff'd,*** 99-2 U.S.T.C. Par. 50,848 (9th Cir. 1999).

The burden of proving insolvency is on the taxpayer. ***Bressi***, T.C. Memo 1991-651.

INSOLVENCY COMPUTATION:

Fair Market Value of Assets (less selling costs)

- Cash
- IRAs/Pensions
- Life insurance (cash surrender value)
- Personal property
- Real property
- Stocks, Bonds, & Other Securities
- Business interests (Partnerships, S-Corporations, LLCs, etc.)
- Accounts/Notes Receivable

Less: **Liabilities**

- Recourse Debt
- Non-recourse Debt

= (Insolvency) / Solvency

Tax Attribute Reduction-Insolvent and Bankrupt Partners

If cancelled debt is excluded under IRC section 108 because a partner is bankrupt or insolvent, he or she must use the excluded amount to reduce net operating losses, capital losses, basis, suspended passive losses, and other tax attributes.

Qualified Farm Indebtedness

Must be done by a "Qualified Person" and the taxpayer must have sufficient tax attributes (IRC section 108(g)).

Qualified Real Property Business Indebtedness

Solvent partners, other than C corporations, may exclude cancellation of Qualified Real Property Business Indebtedness ("QRPBI") income if certain requirements are met (IRC section 108(c)).

- The determination of whether cancelled debt is QRPBI is made at the partnership level. The debt cancelled must be secured by real property used in the trade or business and incurred before January 1, 1993, or be Qualified Acquisition Indebtedness.

- The excluded COD income cannot exceed the partner's share of the difference between the outstanding principal amount of debt (before discharge) and the fair market value of the real property (reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property); and the partner's total adjusted bases of depreciable real property. The outstanding principal amount includes prior year accumulated accrued and unpaid interest (Final Treas. Reg. section 1.108-6(a)).

  Example 8-5

  Partnership owns a building subject to $1.5 million non-recourse debt. Partnership had difficulty making loan payments. Lender agreed to accept $1 million in full satisfaction of the debt. Partnership borrowed $1 million from "new" lender to pay off old loan. "New" lender appraised building at $1.2 million. Partnership realized COD income of $300,000 ($1.5 million - $1.2 million [Fair Market Value]) that is eligible for the QRPBI exclusion. Partnership realized taxable COD income of $200,000 ($ 500,000 Total Debt Canceled - $ 300,000 Excludable COD income) that is not eligible for the QRPBI exclusion.

Old non-recourse debt	$1,500,000
"New" debt	(1,000,000)
Total debt canceled	$ 500,000
Old non-recourse debt	$1,500,000
Fair Market Value	(1,200,000)
Excludable COD income	$ 300,000
Total debt canceled	$ 500,000
Excludable COD income	(300,000)
Taxable COD income	$ 200,000

- The adjusted basis of qualified real property (whose debt was reduced) must be reduced by discharged QRPBI before the adjusted bases of other depreciable real property are reduced (Final Treas. Reg. section 1.1017-1(c)(1)).

- The basis of property acquired in contemplation of cancellation of indebtedness may not be reduced.

- The partner must make a timely election to reduce the bases of his or her depreciable real property (**Note:** Depreciable real property does not include land, furniture and fixtures, equipment or intangible assets). A partnership interest is considered depreciable real property to the extent of the partner's share of depreciable real property. To make the election, the partner uses Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness in the year COD income is received. The partner must attach a detailed description, by property, identifying any reduction in basis under IRC section 1017.

- For the partner's basis in his or her partnership interest to be reduced the partnership must make a corresponding reduction in the partner's share of depreciable real property on its books. If the partnership does not make the reduction, then the partner may not exclude the COD income (See Treas. Reg. section 1.1017-1(g)(2) for general rule and exceptions).

- The partnership must consent to the reduction of partner's share of inside basis if-

  1. The partner owns (directly or indirectly) more than 80 percent interest in the capital and profits of the partnership, <u>or</u>

  2. Five or fewer partners own (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership (See Treas. Reg. section 1.1017-1(g)(2)(ii)(C)).

Partnership Consent Statement (Treas. Reg. section 1.1017-1(g)(2)(iii))

<u>Partnership Requirement:</u>

- Statement must be attached to partnership return (Form 1065) for the taxable year following the year that ends with or within the taxable year the partner excludes COD income.

  ♦ Statement must be provided to the partner on or before the due date of the partner's return (including extensions) for the taxable year in which the partner excludes COD income.

  ♦ Statement must contain the following:
    1. Name, address, and taxpayer identification number of the partnership; <u>and</u>
    2. States the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable real property.

<u>Partner Requirement</u>:

- The partnership consent statement must be attached to the partner's timely filed (including extensions) tax return for the taxable year in which the partner excludes COD income.

- If the property whose debt is reduced is sold in the same year as the debt cancellation, IRC section 1017 (a)(3)(F) requires that the basis reductions be effected immediately before the sale. As a result, basis reductions will be immediately triggered into income (as ordinary income due to IRC section 1245) upon the sale (IRC section 1017(b)(3)(F)(iii)). This immediate recapture normally will take any tax benefit away from IRC section 108(c).

Example 8-6

In 1998 the partnership restructured its debt and realized COD income of $500,000. All of the partners elected to reduce the basis of their partnership interests (considered depreciable real property). On December 30, 1998, the partnership sold all of its real property for $1 million. Prior to the QRPBI basis reduction the adjusted basis of the partnership's real property was $500,000 for the building and $100,000 for the land. The partnership computed its gain on disposition of real property as follows:

Sales Price		$1,000,000
Adjusted Basis before QRPBI Reduction	$500,000	
QRPBI Reduction	(500,000)**	
	-0-	
Land	100,000	
Adjusted Basis		(100,000)
Gain on sale/exchange		$ 900,000**

**$500,000 of gain is considered ordinary income (IRC section 1245). The balance of the gain is IRC section 1231 gain.

Accrued Interest Expense

See sub-chapter B for the treatment of accrued unpaid interest when a property secured by non-recourse debt is sold/foreclosed. See sub-chapter C for the treatment of accrued unpaid contingent interest.

If debt is cancelled during the year, current year accrued interest is not allowable. If interest has been accrued during the year and it will never be paid, there is no fact of liability. The all events test has not been met (IRC section 461(h)(4)). In addition, IRC section 108(e)(c)(2) says to ignore items that would give rise to a deduction.

The outstanding principal amount of QRPBI includes prior year accumulated accrued unpaid interest expense (Treas. Reg. section 1.108-6(a)).

Passive Activity Loss Limitations

COD Income Excluded under IRC section 108(a)(1)(A), (B), (C):

Cancelled debt that is not taxed because a taxpayer is bankrupt (Title 11), insolvent, or has qualified farm indebtedness discharged cannot be passive income on Form 8582 (Passive Activity Loss Limitations) line 1a or 2a. Passive income is only income that is taxed in the current year. If cancelled debt is taxable income under IRC section 61(a)(12), then it may be passive income.

However, COD income that is excluded under IRC section 108(a)(1)(A), (B), or (C) shall be applied to reduce tax attributes of the taxpayer (IRC section 108(b)). Passive activity loss and credit carryovers are considered tax attributes. Tax

attributes (including passive activity losses and credits) that are reduced may never be deducted by the taxpayer.

Taxable COD Income (IRC section 61(a)(12) and Gain on Foreclosure or Sale (IRC section 61(a)(3):

Generally taxable COD income is passive to the extent it is allocated to passive activity expenditures at the time the debt is discharged (Rev. Rul. 92-92). A similar rationale can be applied to gain on foreclosure or sale of property.

There are some exceptions to this general rule. In the following cases COD income or gain on foreclosure or sale of property should be considered non-passive income and should not be on Form 8582 line 1a or 2a:

- Partner is a real estate professional and materially participated in the partnership rental activity in the year income or gain is recognized. See IRC section 469(c)(7) and Treas. Reg. section 1.469-9.

- COD Income and/or gain on foreclosure or sale of property is non-passive if the property was leased to an entity where the investor worked (that is, materially participated – the self-rental recharacterization rule). See Treas. Reg. section 1.469-2(f)(6).

- COD Income and/or gain on foreclosure or sale of property are non-passive if less than 30 percent of the unadjusted basis is depreciable. Income from land, whether held for investment or leased or sold, is non-passive. See IRC section 469(e)(1)(A)(ii)(II) and Treas. Reg. section 1.469-2T(f)(3).

- In the year of disposition, COD income and/or gain on foreclosure or sale of property is recognized but the partnership is not a rental activity or business. See Treas. Reg. section 1.469-2T(c)(2)(A)(I)(3). Whether or not property is rented in the year of disposition is easy to determine. Simply review Form 8825 for rental income and/or advertising expense.

- Even if COD income and/or gain on foreclosure or sale of property is determined to be passive, it does not belong on Form 8582, triggering unrelated passive losses, if current and suspended losses from the activity disposed of exceed income/gain reported from the activity. See IRC section 469(g).

IRC section 469(g) permits the deductibility of all current and suspended losses **IF** there is an entire disposition of a partnership interest in a fully taxable transaction to an unrelated party. Thus, whether or not the character of income attributable to cancelled debt and/or gain on foreclosure/sale is passive or non-passive, all losses (current and suspended) from the partnership will be deductible. If the amount or timing of COD income and/or gain on foreclosure/sale has yet to be determined, there is not a "fully taxable" disposition (that is, all gain/loss realized and recognized) as required by IRC section 469(g). Any legitimate passive income will, of course, trigger deductibility of losses.

While Revenue Ruling 92-92 generally provides that COD income from a passive activity in the taxable year of disposition **IS** passive income, the rules for real estate professionals were enacted beginning in 1994, 2 years later. **If a taxpayer is a real estate professional** (spends majority of his time on real property businesses and/or rentals) **and he or she materially participates in the rental activity** disposed of (performs most of the work or more than anyone else does), **income will be non-passive**. See IRC section 469(c)(7) and Treas. Reg. section 1.469-9. In other words, gain on foreclosure or sale and COD income, while still reportable, may **not** be used on Form 8582 line 1a or 2a to **trigger unrelated passive losses**. Under IRC section 469(f), however, the COD income/gain will **trigger losses from the <u>same</u> activity**. Even if the activity is not disposed of and debt related to the activity is cancelled, it will trigger losses from the same activity, but not from unrelated activities.

Example 8-7

<u>Facts:</u>

Taxpayer is a real estate professional and owns multiple real estate rental activities, some of which are partnership interests. Debt of $2 million is cancelled on one partnership interest. The partner materially participates currently in the real estate partnership or he materially participated any 5 of the prior 10 years (Treas. Reg. section 1.469-5T(a)(5).

Taxpayer has the following suspended and current year losses:

- $1 million in suspended passive losses from the partnership interest.
- $500,000 in current year losses from the partnership interest.
- $200,000 in suspended passive losses from other real estate rental activities.

<u>Computation:</u>

COD Income	$2,000,000
Partnership-suspended passive losses	(1,000,000)
Partnership-current year loss	(500,000)
COD Income-non-passive	$ 500,000

$500,000 of COD income cannot be used to offset unrelated suspended passive losses.

Additional guidance may be found in the **MSSP Passive Activity Guide**. You can also contact the Passive Activity Issue Specialist.

Examination Techniques

The following determinations need to be made during the examination:

1. Whether the partnership realized COD income.

2. Whether the partnership correctly reported COD income.

3. Whether COD income should be recharacterized as gain on disposition of partnership property.

4. Whether the partnership improperly deducted accrued unpaid interest expense in the year the debt was cancelled.

5. Whether the partnership deducted accrued unpaid contingent interest expense and/or included it in COD income (see sub-chapter C).

6. Whether partners correctly report COD income and/or reduced tax attributes. (**Note:** Since additional factual determinations are required at the partner level, an affected item report will need to be prepared.)

7. Scrutinize any depreciable real property acquisitions within 18 months of the receipt of COD income. Interview the taxpayer and lender to determine whether any substantial discussions regarding restructuring partnership debt were held prior to the acquisition of depreciable real property. If there were, the basis of recently acquired depreciable real property may not be reduced in lieu of reporting cancelled QRPBI income.

8. As part of determination of whether debt is recourse or non-recourse, inspect prior year partnership return and Schedules K-1 to see how debt was classified. Balance sheet of partnership return has a non-recourse debt line. However, some partnerships may enter non-recourse debt on the mortgage line of the balance sheet, but also reflect it on the Schedule K-1 as Qualified Non-recourse Financing.

Issue Identification

COD and Basis Reduction:

1. Balance sheet of partnership tax return shows a substantial decrease in liabilities at year-end. This may indicate cancellation of indebtedness income. Real estate partnerships will frequently renegotiate mortgages when the value of real property declines.

2. Other income shown on Schedule K may be COD income.

3. Instead of showing COD income on the individual partner's Schedule K-1 there may be a supplemental statement suggesting that the partner consult their tax advisor on how to report the reduction in debt.

4. Analysis of "old" and "new" loan documents will indicate amount of COD and whether debt is secured by real property. For a partner to exclude COD income under the QRPBI exception, the debt must be secured by real property and the security must be recorded.

5. An appraisal will indicate whether the debt cancelled exceeds the difference between the amount of debt and the fair market value of the real property. The QRPBI exception does not apply to the excess debt cancellation. Therefore, the excess will be taxable income.

6. If solvent partners elected to reduce basis in their partnership interests rather than report COD income (QRPBI exception), the partnership tax return for the year subsequent to the debt discharge should be inspected. The balance sheet of the partnership return should show a decreased basis in real property and the Schedules K-1 should include a statement indicating the amount by which the partners should adjust income for the basis decrease. If partners elected to reduce basis in other depreciable real property (not owned by the partnership), there would not be a statement on the subsequent year Schedules K-1.

7. Analysis of interest expense worksheets/schedules will indicate whether the partnership has improperly accrued interest expense in the workout year. Accrued unpaid interest should not be deducted or included in COD income.

<u>COD versus Sale:</u>

1. If the partnership reports a sale of property and COD income, analyze all loan documents to determine whether loan was non-recourse or recourse. If the loan is determined to be non-recourse, analyze all sales documents to determine whether there were two transactions or one interrelated transaction. If it is determined that there was one transaction, then the full amount of non-recourse debt should be treated as sales proceeds. ***2925 Briarpark Ltd***., TC Memo 1997-298, ***aff'd*** 99-1, Par. 50,209, (5th Cir.).

2. If inspection of the partnership return indicates that COD income was reported, property decreased on the balance sheet, and a loss/very small gain/ or no gain on sale of partnership property was reported, determine whether partnership properly reported transaction.

3. Analyze all loan and purchase/sales documents. If a guarantee of non-recourse debt was made at the eleventh hour, it may not change the status of the loan from non-recourse to recourse. For example, if the guarantee provides that a partner must repay the loan only if he fights the foreclosure sale, this would be considered a contingent guarantee and would not change the loan from non-recourse to recourse. If you have an 11th hour guarantee issue, call a Partnership Technical Advisor.

Documents to Request

1. Partnership Agreement and all amendments.

2. Copies of all loan documents including, but not limited to promissory notes, deeds of trust, mortgages, loan payment histories, loan guarantees and/or loan indemnification agreements.

3. If the loan has been restructured, provide all documents relating to the amended and restated loans.

4. Copies of all purchase/sales documents and settlement sheets.

5. All workpapers, schedules, and documents used to determine amount of cancellation of indebtedness income.

6. Copies of Forms 982, Reduction of Tax Attributes Due to Discharge of Indebtedness.

7. Copies of Forms 1065, U.S. Partnership Return of Income, for subsequent year.

8. <u>QRPBI Issues-</u>
<u>Additional Documents to request:</u>

   (a) All workpapers, schedules, and documents used to determine amount of cancellation of indebtedness income, fair market value of partnership property at time debt was cancelled, and each partner's allocable share of depreciable partnership property.

   (b) Copies of partners' requests to General Partner to reduce basis of partnership property.

   (c) Copies of partnership's consents allowing partners to reduce basis of partnership property.

   (d) Copies of partner's elections (Form 982) to reduce the basis of depreciable real property by their distributive share of the Cancellation of Indebtedness Income. If a partner has reduced basis of property other than partnership property, provide street address of property, percentage ownership, date acquired, cost, depreciable life and remaining adjusted basis at 12/31/XX. In addition, if any of this property is owned by partners as partners in other partnerships, also provide the complete partnership name and address, tax identification

number, name of contact person, telephone number and copy of the subsequent year Schedule K-1 received from this entity.

(e) Any appraisal of partnership property by the old or a new lender and/or by the partnership.

Interview Questions

Depending upon the documents provided by the partnership, the following questions might have to be asked.

1. Was any partnership debt cancelled/reduced/refinanced/restructured?

2. Was partnership debt recourse or non-recourse? Were there any guarantees/indemnification agreements? Was the lender advised of the guarantees/indemnification agreements?

3. Was partnership property sold?

4. How did the partnership determine COD income?

5. How did the partnership determine the gain on disposition of property?

6. Did the partnership make all principal and interest payments in the current/prior years? If not, what was the amount of interest that was not paid in current/prior years? Were there any standstill/forbearance agreements regarding the payment of interest?

7. (QRPBI issue) How did the partnership determine the FMV of partnership property?

8. (QRPBI issue) Which partners requested a reduction in their share of partnership property?

9. (QRPBI issue) Did the partnership consent to the allowance of all partners' requests for reduction in basis of partnership property?

Supporting Law

General rule-IRC section 61(a)(12)
IRC section 61(a)(3)
IRC section 108 Exclusion
IRC section 469 and related Regulations
IRC section 1017
IRC section 6231(a)(5)
IRC section 461(h)(4)
IRC section 7701(g)

Sections 108 and 1017 final Treasury Regulations (applies to discharges after October 22, 1998) and related regulations:

- Final Treas. Reg. section 1.108-4 *Election to reduce basis of depreciable property under section 108(b)(5) of the Internal Revenue Code.*
- Final Treas. Reg. section 1.108-6 *Limitations on the exclusion of income from the discharge of qualified real property business indebtedness.*
- Final Treas. Reg. section1.1017-1 *Basis reductions following a discharge of indebtedness.*
- **Treas. Reg. section 301.9100-2** ***Late Election filed with amended tax return within 6 months of the due date of the original return (excluding extensions)***
- Treas. Reg. section 301.9100-3 *Requests for extension that do not meet the requirements of Treas. Reg. section 301.9100-2.* Taxpayer must prove that he/she acted in good faith, acted reasonably, and that the grant of relief will not prejudice the Government's interests.

Rev. Rul. 91-31. The reduction of the principal amount of an undersecured non-recourse indebtedness (by the holder of a debt who was not the seller of the property securing the debt) results in discharge of indebtedness income under IRC section 61(a)(12).

Rev. Rul. 92-53. The amount by which a non-recourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent within the meaning of IRC section 108(d)(3), but only to the extent that the excess non-recourse debt is discharged.

Rev. Rul. 92-92. COD income is passive income to the extent it is allocated to passive activity expenditures at the time the debt is discharged.

Kirby Lumber, 284 U.S. 1 (1931). Corporation that purchased its own bonds at a discount on the open market realized COD income.

Tufts, 461 U.S. 300 (1983) and IRC section 7701(g). FMV of property securing non-recourse debt shall be treated as not less than the amount of the debt.

Gershkowitz v. Commissioner, 88 T.C. 984 (1987). COD income was realized when non-recourse debt was canceled and debtor retained property.

Merkel, TC Memo 1954-82. Insolvency is the amount by which the taxpayer's liabilities exceed the FMV of the taxpayer's assets immediately before the discharge.

Merkel, 109 T.C. 463 (1997), ***aff'd***, 99-2 USTC Par. 50,848 (9th Cir. 1999). Taxpayers were not allowed to include contingent liabilities (guarantees) in their insolvency computation.

Bressi, TC Memo 1991-651. The burden of proving insolvency is on the taxpayer.

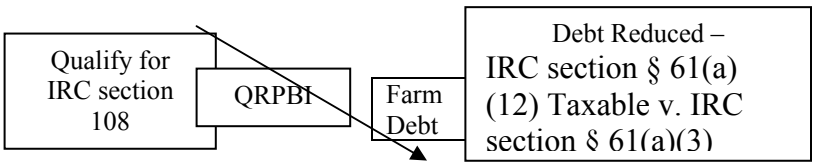
2925 Briarpark, Ltd., TC Memo 1997-298, ***aff'd*** 99-1, Par. 50,209, (5th Cir.). Partnership sold a building subject to non-recourse debt to a third party. The sales proceeds went to the lender who discharged the difference between the debt and sales proceeds. The partnership argued that two transactions had taken place. A discharge of indebtedness where the partnership retained the property, and a subsequent sale. Both courts agreed that there was only one transaction, a sale/exchange and the sales proceeds equaled the amount of the non-recourse debt (***Tufts*** and IRC section 7701(g)). Also, the courts treated the difference between the portion of the debt that was guaranteed and the amount paid to settle the guarantee as ***Tufts*** gain.

The fair market value of assets that are exempt under state law are not excludable in determining insolvency.

Resources

- BNA, Tax Management Portfolio 541
- "A Requiem for Fulton Gold", **Taxes**, (July 1994)
- IRS-Publication No. 541, **"**Partner's Exclusions and Deductions**"**
- MSSP Passive Activity Guide
- "Contingent Debt Taken into Account in Determining Insolvency", The Tax Adviser, (March, 1999)
- "IRS Finalizes Regs. On Basis Reduction Excluded DOI Income", The Tax Adviser, (March, 1999)

CANCELLATION OF DEBT AND PARTNERSHIP/PARTNERS



ISSUE: DISPOSITION OF PROPERTY SUBJECT TO NON-RECOURSE DEBT AND UNPAID INTEREST

When real property subject to non-recourse debt is disposed/sold (that is, sale to third party, involuntary foreclosure sale, deed in lieu of foreclosure, abandonment of property subject to non-recourse debt, etc.), the outstanding mortgage debt is considered sales proceeds (***Tufts v. Commissioner***, 461 U.S. 300 and IRC section 7701(g)). Therefore, the gain (IRC section 1001(a)) will equal the difference between amount of the debt (Treas. Reg. section 1.1001-2(a)(1)) and the adjusted basis of the property regardless of the property's fair market value. In most cases the gain will be treated as capital gain (IRC section 1231) by the partners, unless part/all of the gain has to be treated as differently due to the following provisions:

1. IRC section 1245 - All depreciation on IRC section 1245 property is treated as ordinary income.

2. IRC section 1250 - Excess depreciation above straight-line depreciation is recaptured as ordinary income.

3. Unrecaptured IRC section 1250 gain - For sales of depreciable real property after May 7, 1997, depreciation not recaptured under IRC section 1250 as ordinary income is taxed at 25 percent (straight line depreciation) under IRC section 1(h).

4. Unrecaptured IRC section 1231 losses - Any current year net IRC section 1231 gain, which would otherwise be characterized as capital gain, will be treated as ordinary income to the extent it does not exceed non-recaptured net IRC section 1231 losses. Non-recaptured net IRC section 1231 losses are the aggregate amount of net IRC section 1231 losses for the 5 most recent preceding taxable years reduced by any amount already recaptured in a prior year. This issue would not be raised at the partnership level, but is an "affected item" to be determined by reviewing the individual partner's preceding five income tax returns for the existence of unrecaptured net section 1231 losses (that is, an affected item report must be prepared).

5. IRC section 111 - Tax Benefit Rule may be cited to treat accumulated unpaid accrued interest expense and real estate taxes that will not be paid on the disposition of real estate financed by non-recourse debt as ordinary income. When real estate is sold at a foreclosure sale, a partnership abandons property (tax sale or quit claim deed), or the partnership reconveys the property to the lender (that is, deed in lieu of foreclosure), there will normally be little or no cash available to pay the accumulated unpaid accrued interest and real estate taxes. If real estate is sold and the sales proceeds are sufficient to pay off the outstanding debt, accumulated unpaid accrued interest, and accumulated unpaid real estate taxes, then IRC section 111 does not apply.

Unpaid Accrued Interest

IRC section 163 provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Unpaid current year accrued interest is not allowed in the year of disposition (IRC section 461(h)).

IRC section 461(h)(1) provides:

> For purposes of this subtitle, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.

IRC section 461(h)(4) provides:

> For purposes of this subsection, the all events test is met with respect to any item if all events have occurred which determine the **fact** of liability and the amount of such liability can be determined with reasonable accuracy.

Treas. Reg. section 1.461-4(e) provides that economic performance occurs as the interest economically accrues.

At the time of disposal or sale of the property, there is no liability to pay any interest. If interest has been accrued during the year and it will never be paid, there is **no fact of liability**.

Prior year accrued unpaid interest expense should be recaptured as ordinary income to the extent of *Tufts* gain (loan balance +accrued interest-adjusted basis).

IRC section 111(a) provides that "Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter."

Therefore, a taxpayer that has deducted an expense in a prior year and received a tax deduction (that is, **tax benefit**) for the expense should have to recapture the expense in income in the year it is determined the expense will never have to be paid.

Example 8-8

Non-recourse debt exceeds fair market value

FACTS:

DEBT	1,000,000
ACCUMULATED ACCRUED INTEREST	125,000
CURRENT YEAR ACCRUED INTEREST	25,000
FMV	500,000
ADJUSTED BASIS	100,000

ADJUSTMENTS:

DEBT (AMOUNT REALIZED)	1,000,000
ADJUSTED BASIS	(100,000)
GAIN ON SALE	900,000

ACCRUED INTEREST INCOME (IRC section 111(a))=125,000
DEDUCTION CURRENT YEAR INTEREST EXPENSE=-0-

Example 8-9

Non-recourse Debt and new lender (***Allan, supra,)***

If debt is with a new lender or there is a 3rd party guarantor or insurer, an issue can be raised under IRC section 111. However, the 8th Circuit ruled differently in ***Allan, et al. v. Commissioner***, U.S. Court of Appeals, 8th Circuit, 86-2268, September 16, 1988. **Currently, this decision is being followed only in the 8th Circuit.**

In this case a partnership owned an apartment building subject to a non-recourse HUD insured mortgage. The partnership was in default and HUD acquired mortgage from lender. HUD paid the real estate taxes on behalf of the partnership. According to the mortgage terms, HUD added unpaid accrued interest and the taxes it paid to mortgage principal. Interest was also charged on the additions. The partnership transferred property to HUD in lieu of foreclosure. The partnership treated the mortgage principal, unpaid accrued interest, and unpaid real estate taxes as sales proceeds (***Tufts*** and IRC section 7701(g)). The Court of Appeals determined that the additions of the unpaid accrued interest and real estate taxes to the mortgage principal were like new loans (that is, mortgage principal) to the partnership from a third party that were used to pay the interest and taxes.

Example 8-10

Using same facts as in Example 8-8:

ADJUSTMENTS:

DEBT	1,000,000
ACCUMULATED ACCRUED INTEREST	125,000
SUB-TOTAL (AMOUNT REALIZED)	1,125,000
ADJUSTED BASIS	(100,000)
GAIN ON SALE	1,025,000

The deduction for current year interest is zero.

Examination Techniques

To determine whether the partnership has deducted accrued unpaid interest expense, inspection and analysis of loan documents, loan payment histories, and interest expense schedules/workpapers is required.

Issue Identification

1. Comparison of the current and prior year partnership tax return balance sheet shows an increase in liabilities. This may be due to the accrual of unpaid interest expense.

2. A schedule attached to the partnership tax return may list an account called "Accrued Interest Payable."

Documents to Request

1. Partnership Agreement and all amendments

2. Copies of all loan documents including, but not limited to promissory notes, deeds of trust, mortgages, loan payment histories, loan guarantees and/or loan indemnification agreements.

3. Copies of all purchase/sales documents and settlement sheets.

4. All workpapers, schedules, and documents used to determine amount of interest expense deduction

5. Copy of audited financial statements.

6. Copies of Forms 1065, U.S. Partnership Return of Income, for prior and subsequent year.

Interview Questions

1. In the year of disposition of partnership property did the partnership deduct accrued and unpaid interest? If yes, what was the amount of the deduction?

2. Did the partnership include accumulated accrued and unpaid interest expense in the amount realized upon disposition of the partnership property? If yes, what was the amount included?

Supporting Law

IRC section 111
IRC section 163
IRC section 461(h)
IRC section 1001(a)
IRC sections 1231, 1245, & 1250
IRC section 7701(g)
Treas. Reg. section 1.461-4(e)
Treas. Reg. section 1.1001-2(a)

Tufts v. Commissioner, 461 U.S. 300, and IRC section 7701(g) ─ The non-recourse obligation is considered sales proceeds.

Allan, et al. v. Commissioner, 86 TC 655, U.S. Court of Appeals, 8th Circuit, 86-2268, September 16, 1988, 856 F.2d 1169 ─ If debt is with a new lender or there is a third party guarantor, then IRC section 111 interest income issue can be raised, except in the 8th Circuit.

McConway & Torley Corp. v. Commissioner, 2 T.C. 593.
Shellabarger Grain Products Co., 2 T.C. 75.
Courts did not allow deduction for current year unpaid accrued interest in year debt was canceled.

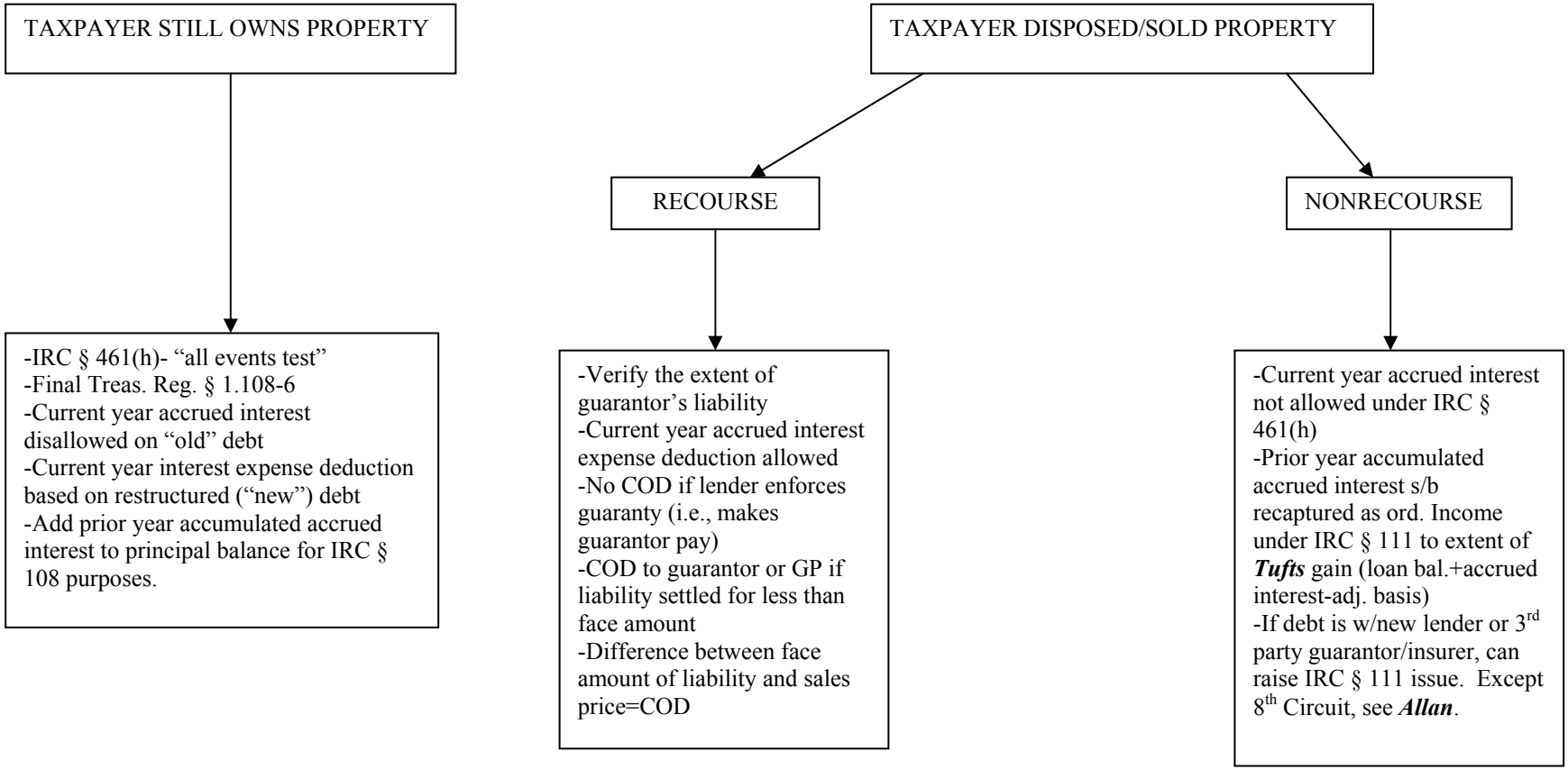
Theodore A. Frederick, et al. v. Commissioner, 101 T.C. 35 ─ This case provides an excellent background on the tax benefit rules (IRC section 111). However, the facts in this case do not deal with the disposition of real property subject to non-recourse debt.

Hillsboro Natl. Bank v. Commissioner, 460 U.S. 370 (1983) ─ Background on tax benefit rules (IRC section 111). Referred to in ***Frederick***.

Resources

Publication 544 - Sales and Other Dispositions of Assets

ACCRUED INTEREST



ISSUE: ACCRUED CONTINGENT INTEREST

In situations where an accrual basis borrower is having difficulty making loan payments a lender may modify the non-recourse loan terms. For example, a lender may require that interest be paid only to the extent of available cash flow and any unpaid balance will be payable in the future. In other words the lender will only be paid the "accrued" interest if the property securing the non-recourse debt appreciates in value sufficiently to pay it out of sales or refinancing proceeds. This type of loan modification is called a **Standstill or Forbearance Agreement**.

In some cases the lender won't modify a non-recourse loan and the borrower will accrue, deduct and fail to pay interest year after year.

As previously discussed, interest could only be accrued and deducted in the year that the liability to pay becomes definite and absolute, regardless of the actual time of payment (IRC section 461(h)(1) and (4), Treas. Reg. section. 1.461-4(e)).

If the obligation to pay interest is wholly contingent upon the happening of a subsequent event (that is, cash flow, profitability, etc.) that can be manipulated, then interest may not be accrued and deducted until the contingency is satisfied.

In ***Pierce Estates, Inc. v. Commissioner***, 195 F.2d 475 (3rd Circuit 1952) the taxpayer used the accrual method of accounting. Interest was payable only if the company had **"net income that was declared by board of directors"** (**contingency**). In its conclusion, the court stated:

> If the liability to pay the item of expense is wholly contingent upon the happening of a subsequent event, the item cannot be regarded as incurred or deductible as accrued until the year in which by the occurrence of the event the contingent liability becomes and absolute one.

In ***Peoples Bank & Trust Co.***, 50 T.C. 750, the bank paid interest on deposits on May 1st and November 1st. Interest paid on May 1st was contingent upon whether funds were still on deposit as of close of business on April 30th. The bank used the accrual method of accounting and the calendar year. An "experience" factor was used to calculate interest expense deducted for November and December. The Tax and Appeals Courts determined that the bank had no liability for interest until May 1st. Therefore, the "all events test" had not been met and the deduction for interest expense was disallowed. In addition, a change in accounting method (IRC section 481) adjustment was made

In ***Burlington-Rock Island Railroad Company***, 321 F.2d 817, the taxpayer used the accrual method of accounting. It entered into an "Allocation Agreement" that required payments on judgements owed "*** from time to time, insofar as its cash situation will reasonably permit." It accrued an interest deduction. However, the interest was not paid. The judge denied Burlington's interest deduction.

In situations where there is no Standstill or Forbearance Agreement and the borrower has been in default (that is, not paying the required principal and interest

on the non-recourse loan) for multiple years, the liability to pay interest will be considered subject to a contingency. However, prior to considering whether the interest payment is subject to a contingency the examiner should determine if a "true" debt exists (that is, debt versus equity).

The accrual of interest expense involves the timing of claiming a deduction (Treas. Reg. section 1-446-1(e)(2)). If it is determined that interest expense has been improperly deducted, then a change in the taxpayer's method of accounting should be made. In addition to the current year disallowance of the contingent interest expense deduction a cumulative adjustment will need to be made for the contingent interest expense improperly deducted on prior year returns (IRC section 481(a) adjustment). This adjustment prevents the duplication of the expense and reflects the difference between the "new" and "old" treatment of interest expense as of the beginning of the year of change. The IRC section 481(a) adjustment should be made in the earliest year of the examination and no 4-year spread should be allowed (Notice 98-31 and Rev. Proc. 97-27).

If a positive IRC section 481(a) adjustment over $3,000 is made, then the adjustment is subject to IRC section 481(b) and the related regulations. IRC section 481(b) provides that the additional tax (increase in tax) attributable to the IRC section 481(a) adjustment is the lesser of the increase in tax computed:

1. With the net adjustment (IRC section 481(a)) included in income in the year of change

2. Under the 3-year (spread-back) allocation rule of IRC section 481(b)(2)

3. Under the specific allocation rule of IRC section 481(b)(2)

Since the IRC section 481(b) computation will be made at the partner level and requires additional factual determinations, an affected item report must be prepared (Treas. Reg. section 1.481-2(c)(5).

Examination Techniques

To determine whether the partnership has deducted accrued contingent interest expense, inspection and analysis of standstill/forbearance agreements, loan documents, loan payment histories, and interest expense schedules/workpapers is required.

Issue Identification

1. Comparison of the current and prior year partnership tax return balance sheet shows an increase in liabilities. This may be due to the accrual of contingent interest expense.

2. A schedule attached to the partnership tax return may list an account called "Accrued Interest Payable."

3. Review of financial statements may indicate that partnership is not deducting contingent interest expense on financial statements, but is deducting it on tax returns. Notes to financial statements may identify the standstill/forbearance agreement, etc. that requires the partnership to pay interest only when it has cash flow.

Documents to Request

1. Partnership Agreement and all amendments

2. Copies of all loan documents including, but not limited to promissory notes, deeds of trust, mortgages, loan payment histories, loan guarantees, /or loan indemnification agreements, standstill/forbearance agreements.

3. All workpapers, schedules, and documents used to determine amount of interest expense deduction

4. Copy of audited financial statements.

5. Copies of Forms 1065, U.S. Partnership Return of Income, for prior and subsequent year.

Interview Questions

1. Did the partnership deduct accrued and unpaid interest? If yes, what was the amount of the deduction?

2. Why didn't the partnership pay interest?

3. Was there an agreement between the lender and the partnership that permitted the nonpayment of interest until there was cash flow, profitability or until some other contingency was satisfied?

4. What was the amount of the accumulated accrued and unpaid interest expense deducted on prior year tax returns?

Supporting Law

IRC section 163
IRC section 446 and related regulations
IRC section 461
IRC section 481 and related regulations
Notice 98-31
Rev. Proc. 97-27

Pierce Estates, Inc. v. Commissioner, 195 F.2d 475 (3rd Circuit 1952)

Peoples Bank & Trust Co., 50 T.C. 750.

Burlington-Rock Island Railroad Company, 321 F.2d 817

Resources

Change in Accounting Method Technical Advisor.

ISSUE: BANKRUPTCY

A financially troubled partnership and/or partner may file a petition in bankruptcy court. Bankruptcy is a condition existing as the result of the actual filing of a petition under the Bankruptcy code. The bankruptcy statutes are contained in Title 11 of the United States Code. They provide the structure within which an individual, a partnership, or a corporation can seek relief from creditors through liquidation or reorganization.

There are five chapters in the bankruptcy code under which bankruptcy proceedings are commenced, administered and closed. They are:

Chapter 7 – Liquidation
Chapter 9 – Adjustment of the Debts of a Municipality
Chapter 11 – Reorganization
Chapter 12 – Adjustments of Debts of a Family Farmer with Regular Annual Income
Chapter 13 – Adjustments of Debts of an Individual with Regular Income

A bankruptcy under any chapter may be voluntary or involuntary. It is **voluntary** if the debtor files the petition and **involuntary** if the creditors file the petition. A debtor does not have to be insolvent to file a bankruptcy petition. With the commencement of a bankruptcy proceeding, an **automatic stay** is triggered. It precludes a creditor from continuing collection activities against the debtor. Thus, a debtor with cash flow problems may file for bankruptcy protection. A bankruptcy stay will stop foreclosure actions and many IRS assessment and collection actions.

Most partnership and partner bankruptcies are filed under Chapter 11 and Chapter 7. Title 11 encompasses both chapters. It is necessary to determine which Chapter the taxpayer actually filed under to determine the tax consequences. Both will be discussed in more detail.

Bankruptcy Basics

Per IRM 4.10.3.1.3:

Chapter 7 – Liquidation: A bankruptcy case in which all of the debtors (individual, corporation, or partnership) non-exempt assets are liquidated (sold) by the trustee to pay creditors' claims or are abandoned. The petition may be

voluntarily or involuntarily filed. Typically, the debtor has no hope of continuing business operations and/or paying debts.

Chapter 11- Reorganization: A bankruptcy case in which debtors (individual, corporations, or partnerships) are allowed to restructure (reorganize) their debts, either by reducing their debts and/or extending the time for payment rather than liquidate. To be confirmed by the Bankruptcy Court, the reorganization plan must be proposed in good faith and the creditors must be paid at minimum an amount equal to what they would have received had the case been filed a Chapter 7- liquidation bankruptcy. The debtor usually remains in possession of the assets (called a debtor- in-possession or DIP) and has the same fiduciary duties and responsibilities as a trustee to general creditors. A trustee can be appointed by the Bankruptcy Court if the creditor can show cause. A debtor may also choose to liquidate its assets in a Chapter 11 case.

Frequently a debtor will file under Chapter 11 and convert to a Chapter 7.

The Administrative Office of the United States Courts in Washington, D.C. publishes a Bankruptcy Division Public Information Series. There is an information sheet for each of the Bankruptcy Chapters that discusses the basic concepts. The sheets are available from the local District Bankruptcy Court. The following information is taken from them:

> Chapter 7 "One of the primary purposes of bankruptcy is discharging debts to give an honest individual debtor a "fresh financial start". The discharge has the effect of extinguishing the debtor's personal liability on dischargable debts. In a chapter 7 case, however, a discharge is available to individual debtors only, not to partnerships or corporations (11 U.S.C. section 727(a)(1)). Although the filing of an individual chapter 7 petition usually results in a discharge of debts, an individual's right to discharge is not absolute. A bankruptcy discharge does not extinguish a lien on property."
>
> "The primary role of a chapter 7 trustee in an "asset" case is to liquidate the debtor's nonexempt assets in a way that maximizes the return to the debtor's unsecured creditors *** the trustee will attempt to liquidate the debtor's nonexempt property. This includes both property that the debtor owns free and clear of liens and property which has a market value above the amount of any security interest or lien and any exemption (lawsuits) belonging to the debtor, and will pursue the trustee's own causes of action to recover money or property under the trustee's "avoiding powers"".
>
> "Most claims against an individual chapter 7 debtor are discharged. A creditor whose unsecured claim is discharged may no longer initiate or continue any legal or other action against the debtor to collect the obligation. Among the debts which are not discharged in a chapter 7 case are alimony and support obligations; certain taxes; debts for certain educational loans made or guaranteed by a governmental unit and debts for personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated from alcohol or other substances. 11 U.S.C. section 523(a)"

"Because secured creditors retain some rights which may permit them to seize pledged property, even after a discharge is granted, a debtor wishing to keep possession of the pledged property, such as an automobile, may find it advantageous to "reaffirm" the debt rather than surrender the property*** The debtor may repay any debt voluntarily, whether a reaffirmation agreement exists (11 U.S.C. 524(f))."

Chapter 11 "The plan must be voted upon by those creditors who are "impaired" meaning those whose contractual rights are to be modified or who will be paid less than the full value of their claims (11 U.S.C. section 1126)."

"Like a corporation, a partnership exists separately and apart from its partners; however the partners' personal assets may, in some cases, be used to pay creditors in the bankruptcy case; or the partners may; themselves, be forced to file for bankruptcy protection."

"Under certain circumstances, such as when the debtor has no equity in the particular property and that property is not necessary for an effective reorganization, the secured creditor can obtain an order from the court granting relief from the automatic stay to foreclose on the property, sell it, and apply the proceeds to the debt (11 U.S.C. section 362(d).

"While some courts have a practice of issuing a discharge order in individual cases, a separate order of discharge is usually not entered in a chapter 11 case, because the discharge given to the debtor is one of the effects of confirmation as set forth at 11 U.S.C. section 1141(d). Section 1141(d)(1) provides that the confirmation of a plan discharges the debtor from any debt that arose before the date of confirmation. After the plan is confirmed, the debtor is required to make plan payments and is bound by the provisions of the plan or reorganization. The confirmed plan or discharge creates new contractual rights, replacing or superseding prebankruptcy contracts.

There are certain types of debtors and debts that cannot be discharged. For example, certain types of debt are denied discharge under section 727(a). In addition if the debtor is a corporation or partnership, confirmation of the plan does not discharge the debtor if the plan is a liquidation plan, and if the debtor does not engage in business after "consummation" of the plan. If the debtor is an individual, the debts excepted under 11 U.S.C. section 523(a) are not discharged."

Bankruptcy Code Section 554 provides that a trustee in bankruptcy may abandon assets that are burdensome or of inconsequential value to the estate. The courts have held that the abandonment of an asset relates back to the commencement of the case, so that the burdensome asset never even enters the estate. ***Nevin*** 135 B.R. 652 (***Bankr***. D. Haw, 1991), ***Dewsnup*** (1990, CA10 Utah), ***Saunders Tool Supply, Inc***. (1987 BC MD Fla) 73 BR 55.

Partnership Bankruptcy

Return Filing Requirements

The filing of a bankruptcy petition does not create a separate taxable entity, IRC section 1399, nor does it terminate the partnership. A partnership is deemed

terminated only when it is no longer carrying on any business, financial operation or venture, or there has been a sale or exchange of 50 percent or more of the partnership interests in capital and profits within a 12 month period, IRC section 708.

Since there is not a separate bankruptcy estate, a Form 1065 should be filed that shows all of the partnership activities for the entire year. Several scenarios can arise:

1. No return is filed.
2. A trustee files a 1065 that reflects only the activity occurring under the administration of the bankruptcy court.
3. A partner files a return reflecting only prepetition activity or activity with respect to abandoned property.
4. The trustee and a general partner both file returns

If no return is filed, substitute for return procedures must be followed. If there is a debtor in possession with respect to all of the partnership assets, a general partner can act on behalf of the partnership. Generally, it will be the general partner with the largest interest.

The instructions to the Form 1065 state that a trustee will file a return for a partnership in bankruptcy. IRC section 6012 addresses a trustee filing a return on behalf of an individual or a corporation in bankruptcy but not a partnership. Chief Counsel Directives Manual relies upon ***Riverside-Linden Inv. Co***., 99 B.R. 439, 446 (9th Cir., BAP 1989) in stating that the trustee in bankruptcy is responsible for filing a partnership tax return. There are authors that question whether a return filed by a trustee is legally valid. IRC section 6063 requires one of the partners to sign a partnership tax return.

A partnership return is an information return. If an agent is dealing with a non-TEFRA return, the tax impact is only on the partners. Each individual partner is entitled to full legal process with respect to any proposed deficiency. Thus whether the trustee or a general partner filed an original return is irrelevant with respect to the partner's tax return.

There are penalties for failure to file a required return and timely furnish a Schedule K-1 to partners. If neither the trustee nor a general partner files a return, Counsel should be consulted with respect to any potential liability based on the facts and circumstances of the case.

If a case falls under the provisions of TEFRA, the examiner must follow TEFRA procedures. Under these procedures only a Tax Matters Partner is eligible to act on behalf of the partnership. A trustee in bankruptcy is not qualified as a TMP (See IRC section 6231). The agent needs to determine who is the TMP in order to issue the NBAP, secure agreements, and secure statute extensions. Even if a trustee for the bankruptcy court filed a partnership tax return, he or she is not empowered to be a tax matters partner.

Debt Forgiveness

In a Chapter 7 bankruptcy or liquidation of a partnership, it is clear that the assets are to be sold and the creditors are to be paid. Each sale must be considered as if it occurred outside the bankruptcy court since the filing of a petition for bankruptcy protection does not create a separate taxable estate. Gain or loss must be determined on an asset by asset basis. Keep in mind that the bankruptcy schedules show the fair market value of assets and not the tax basis.

If the proceeds of the sale exceed the debt, then the excess will be distributed to the partners. Any gain is fully taxable to the partner since there is a sale or exchange rather than cancellation or debt. A partner may not exclude the gain because a bankruptcy trustee handled the sale.

If the proceeds of the sale are insufficient to pay the debt, then the general partners are still liable. The trustee and/or the creditors may take legal action against the general partners. The suit is filed with the court that would have jurisdiction over the debt if the bankruptcy petition had not been filed. The trustee may receive a judgement against the general partners, which will become an asset of the bankruptcy estate. If the creditors file suit against the general partners, the court will generally issue a deficiency judgement against the partners. This information will not be contained in the bankruptcy file. If the partner's all pay the proportionate share of the remaining debt, then there are no additional issues. If one partner pays more than his or her share of the debt, then you must look to any deficit restoration agreement and the legal rights the payer partner has against the other partners for co-contribution.

The bankruptcy file may contain the court and file numbers for related litigation.

Frequently, neither the trustee nor the creditors take legal action against the general partners. If this is the case, the issue is, when is the debt forgiven? The courts have held that debt is forgiven when the facts reasonably establish that the debt will probably never be repaid, the taxpayer does not intend to repay to debt, and the creditor does not intend to enforce it's claim against the taxpayer. (***M.A. Slavin v. Commissioner***, 57 T.C. Memo 1989-221.)

If the assets are gone, and the partnership is no longer conducting business, a final partnership return should be filed and the individual partners will determine any gain or loss on the termination.

In a chapter 11 proceeding the intent is to restructure the debt or reorganize the partnership. A plan of reorganization is submitted to the court. The majority of creditors must approve the plan. The plan is then confirmed by the court and is binding on the debtor. A revenue agent will have to look at any debt that is modified and determine if the material modification rules of IRC section 1001 apply. Under Treas. Reg. section 1.1001-3(c)(iii), a modification occurs upon the effective date of the plan.

Other issues to consider with respect to a partnership bankruptcy are the deductibility of expenses and allocations. Administrative expenses of bankruptcy are generally deductible. To the extent that they relate to the reorganization of the partnership, they may have to be capitalized.

Where there are significant tax effects, the partnership may attempt to allocate the gain to a partner where the impact will be minimal. Any allocation must satisfy the substantial economic effect requirements and the partnership minimum gain provisions of IRC section 704.

Each Schedule K-1 should clearly reflect any income from a sale or exchange and any income that qualifies as cancellation of indebtedness (COD). Watch for recourse and non-recourse debt and "***Tufts***" gain.

Under IRC section 108(d) the determination of whether COD income is excludable is made at the partner level. The fact that the partnership filed for bankruptcy does not mean that any income is excludible because COD arose during the jurisdiction of the bankruptcy court. The partner must be actually file for bankruptcy or meet the insolvency exception provided in IRC section 108.

Partners Bankruptcy

This section will address the filing of bankruptcy by a partner who is an individual.

Return Filing Requirements

If a partner who is an individual files for bankruptcy, a separate taxable estate is created. The estate is separate and distinct from the individual debtor. At the date of the petition all of the debtors non-exempt assets and liabilities pass to the bankruptcy estate. Among the assets that pass are the taxpayers tax attributes: NOLs, carryover contributions, recovery of tax benefit items, credit carryovers, basis, method of accounting, passive activity losses, unused at-risk deductions and any other item specified in the regulations. No gain or loss occurs upon the transfer of the assets, liabilities, and attributes to the bankruptcy estate. The gross income of the bankruptcy estate includes any of the debtor's gross income to which the estate is entitled under bankruptcy law. The estate's gross income also includes any income the estate is entitled to and receives or which accrues after the commencement of the bankruptcy estate. (IRC section 1398).

Exempt assets are determined under state law. In general, exempt assets include a limited interest in a personal residence and personal property such as an automobile and clothing. Many states have adopted the exemptions set forth in Section 522 of the Bankruptcy Code.

The individual debtor is responsible for reporting any personal income or expense after the date the bankruptcy is commenced. He or she is responsible for filing personal income tax returns for income prior to the commencement of the bankruptcy case and income after the bankruptcy case that does not belong to the bankruptcy estate. If married one or both spouses may file for bankruptcy. The taxpayer can elect to file a short period return for the period prior to the commencement of the bankruptcy estate. See Publication 908, Bankruptcy Tax Guide for additional details

The trustee of the estate or the debtor in possession is responsible for filing a fiduciary return (Form 1041) for the bankruptcy estate.

Warning: The filing of a petition in bankruptcy disqualifies the individual debtor as a tax matters partner in TEFRA proceedings. In addition it converts the debtor partner's TEFRA items to non-TEFRA items and starts the running of the 1-year assessment date provided for in IRC section 6229. Advice has been received that this period should not shorten the normal 3-year statute of limitations provided for in IRC section 6501. This issue has not been litigated. The current position is to protect the one-year period. Contact your TEFRA Coordinator for assistance.

The individual debtor is required to file the bankruptcy schedules listed at the beginning of the discussion on bankruptcy.

These schedules will detail what the assets and liabilities of the partner are at the date of the petition. These are the assets that pass to the bankruptcy estate unless they are exempt. On the personal property schedule, the partnership(s) interest should be listed with a fair market value assigned. In the secured liability schedule, a partnership interest may be shown as security for a debt. In addition partnership debts may be listed on either the secured or unsecured schedule.

The trustee or the debtor in possession may offer the partnership interest for sale just as he would any other asset. Generally they are offered for sale to the other partners as most partnership agreements have restrictions on the admission of new partners. If the interest is sold while held by the estate, then there is a taxable gain or loss based on the difference between the proceeds and the partner's basis that was transferred to the estate.

If the asset is burdensome to the estate or of inconsequential value, it may be abandoned back to the partner. If the tax basis is low the estate may want to abandon the interest as a sale may produce adverse tax consequences. Whoever sells the property is liable for any tax due. A trustee sold property and attempted to

abandon the proceeds to the debtor. The court held the estate liable for the tax. (***Bentley***, 916 F2nd 431, 8th Cir. 1990). A trustee will also abandon property that is pledged as security for a debt that exceeds the property's value.

One collateral consequence of this is that if a partnership interest is abandoned back to a partner, then the related tax attributes go with it. For example, passive loss carryovers related to an abandoned partnership will be returned to the debtor (See Treas. Reg. section 1.1398-1(d)) as well as all income and expense related to the property.

A partner will list partnership debt on his or her personal bankruptcy schedule. Usually this is because the debt is recourse or the debt is non-recourse but has been guaranteed by the partner.

Debt Forgiveness

Just because a debt is listed on a bankruptcy schedule, it does not mean that it is forgiven.

In chapter 7, the court discharges the partner's personal debt unless they are non-dischargable. If a debt is fully secured it is not discharged since the court cannot discharge a lien. The creditors claim will show the amount or the debt that is secured and the amount that is unsecured. See the general discussion above with respect to general debts and the Bankruptcy Handbook (IRM 4.3.2) for additional information.

A court cannot discharge a partnership debt since it is the partner who is under court jurisdiction. A guarantee is however discharged. A debt that was recourse will be converted to non-recourse. Thus, a partner will have a deemed distribution that may result in taxable gain if the distribution exceeds the partner's adjusted basis of its partnership interest.

The actual discharge of the individual debtor may be as early as 60 days after a chapter 7 petition is filed. The bankruptcy estate may continue for a substantial period of time beyond the discharge.

In a chapter 11 case, any debt modifications will be spelled out. As with a partnership consideration must be given to the material modification rules set forth in IRC section 1001 and the regulations thereunder.

Income Issues

Under IRC section 706, a partner recognizes the partnership income or loss in the tax year in which the partnership's taxable year-end occurs. Thus if a partner files for bankruptcy a separate bankruptcy estate is created. If the partnership's year-end is after the petition date but prior to the estate's year end, the partnership income or loss is allocated to the estate for the entire year. ***Aron B. Katz, etux.v. Commissioner***; 116 T.C. No.2 (January 12,2001). Determination of the owner of a partnership interest at year-end is critical to determine who is taxable on any income or loss.

If a bankruptcy case is dismissed, it is as if no petition was ever filed. Amended returns are required to reallocate any income/expense reported by the estate back to the individual debtor.

If a debt is converted from recourse to non-recourse it is a deemed distribution under IRC section 752.

Court Records

Frequently, the agent is examining a return subsequent to the bankruptcy termination. On a partnership Schedule K-1, cancellation of debt may be reflected as "Other Income" or there may be a notation that the assets have gone through foreclosure or bankruptcy. The individual partners may or may not reflect the information on their individual Forms1040 depending on the knowledge and skill of the person preparing the tax return. Often partners in the same circumstances and in the same partnerships will have inconsistent positions in the manner they reported it on their personal returns.

To make a proper determination of a partner's tax liability, the examiner's first step is to determine what was sold and what was forgiven. In order to do so a basic understanding of bankruptcy is necessary. It is a highly complex area of law. The agent should review the bankruptcy file and interview the taxpayer to obtain the facts. Usually it is clear if an asset was sold or debt was forgiven. If there is any question, a request should be made for a legal opinion from Counsel.

A taxpayer/debtor often believes that there are no tax implications as they lost the property. Since the bankruptcy is closed, they believe that all related matters are also closed. This is incorrect, as audit issues may still be raised on non-bankrupt partners, and proof of claims filed against the bankrupt partners.

The files at the US Bankruptcy Court contain a wealth of information. It is all public record. The filing of the petition requires the completion of detailed financial records. The petitioner is required to submit the following schedules when they file for bankruptcy protection:

A –Real Property
B – Personal Property
C – Property Claimed as Exempt
D - Creditors Holding Secured Claims
E – Creditors Holding Unsecured Priority Claims
F – Creditors Holding Unsecured Nonpriority Claims
G – Executory Contracts and Unexpired Leases
H – CoDebtors
I – Current Income of Individual Debtors
J – Current Expenditures of Individual Debtors

For both partnerships and partners, the schedules provide a balance sheet at the date of filing the bankruptcy petition. It should be kept in mind that the assets are listed at their fair market value rather than their tax basis.

A series of questions in the schedules will provide a revenue agent with information on other litigation, related parties, and recent asset transfers.

Listed creditors are notified of the filing of the bankruptcy and are generally given 90 days to file a claim. If a debtor lists the debt as non- liquidated and non-contested in the schedules, no formal claim is required from creditors as it is deemed to be correct. All other creditors must file formal claims to state the amount and basis of the claim. As a proof of claim, the creditor will often attach the legal contract that gave rise to the debt or invoices previously submitted to the debtor.

Throughout the period of administration income and expense reports are filed with the bankruptcy court. If there is a receiver or a debtor in possession in a Chapter 11 case, the reports are required on a monthly basis.

The trustee or the debtor in possession has the right to set aside or void an executory contract or lease that is not favorable to the debtor.

When the bankruptcy is finalized a final accounting is contained in the bankruptcy file.

The bankruptcy file contains an index that lists all documents contained within the file. When a revenue agent learns of a bankruptcy, he should review the bankruptcy files. Many of the Bankruptcy Courts have a web site containing detailed

information that can be reviewed or downloaded by computer. Some of the courts are scanning in certain documents received. Actual records may be reviewed at the bankruptcy court. If this is not practicable, then the agent should request from the clerk of bankruptcy court copies of the petition, related schedules, index, and final accounting.

Examination Techniques

Prior to or during an examination, an agent may become aware that a partnership and/or a related partner have filed for bankruptcy protection in one of the following ways:

- The courts are to inform Special Procedures with respect to bankruptcies filed within their jurisdiction. After notification, Special Procedures researches the debtor's tax filings and notifies Compliance if the debtor has an open income tax examination.
- The agent may find out prior to receiving official notice.
- The taxpayer may tell him/her that he/she filed.
- There may be a bankruptcy freeze code on the case.
- The agent may receive an AIMS update with the bankruptcy freeze code.
- There may be some indication on the return that the taxpayer is in bankruptcy. For example, the taxpayer may have filed Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness in the year COD income is received).
- The agent may see it in the newspaper.

The agent must immediately evaluate the case. Collectibility needs to be considered (IRM 4.3.2). A survey or limited scope audit may be appropriate.

With respect to any open case, the examining agent is responsible for notifying Special Procedures with the amount of the deficiency or a reasonable estimate thereof. Some taxes are not dischargable in bankruptcy. However, a detailed discussion is beyond the scope of this guide. The claim to be submitted to the bankruptcy courts is for all taxes, interest, and penalties with respect to any taxes due for any prepetition period. It includes assessed amounts and potential audit deficiencies. The bankruptcy court sets a date by which all claims by creditors must be filed. This date is know as the bar date. If a claim is not timely filed it is not allowed. In general, a claim may later be perfected but not for a larger amount.

Since a partnership is not a taxable entity, frequently there is no claim to submit. However, consideration should be given to any liability for employment and excise

taxes. The filing of a petition by an individual partner creates a bankruptcy estate, which is separate and distinct from the taxpayer. Taxes incurred by the estate during the period of administration of the estate are deductible by the estate. The trustee may make a request for prompt assessment. The tax determination must be made within 180 days of the receipt of the request. See IRM 4.2.10.5.2. Prompt assessments do not apply to partnerships as no separate taxable estate is created.

District Counsel must be notified under the following circumstances: (IRM 4.3.10.1.3)

1) Significant Processing Procedures (IRM 4.3.10.5.2)
   A) CEP cases
   B) Cases with coordinated issues
   C) Cases with technical advice pending
   D) Cases with assets of $50 million dollars or more
   E) Cases where the tax liability may exceed $1 million or the assessed liability exceeds $10 million
   F) Cases where the potential tax liability may generate significant publicity
   G) Cases where a criminal tax prosecution is being considered or pending
   H) Past or present subsidiaries that joined in filing consolidated returns with a parent that meets the above criteria
   I) Parent corporations where the past or present consolidated subsidiaries meet the above criteria
   J) Cases where the agent deems it warranted
   K) Cases with difficult or significant post confirmation tax issues
   L) Cases that involve excise tax or ERISA issues
   M) Prepackaged bankruptcies
2) Litigation is brought against the IRS in the bankruptcy proceeding
3) Consideration is being given to referring the taxpayer to Criminal Investigation
4) Consideration is being given to asserting a transferee liability
5) Assets were transferred within 90 days prior to the bankruptcy petition

Issue Identification

<u>Partnership</u>

- Have all assets and debt dispositions been accounted for?
- Are there sales or exchanges?
- Is there debt forgiveness?
- Has there been a material modification of debt?
- Will a change in the debt qualify as a purchase price adjustment?
- Was any of the debt acquired by related parties?
- Was all income reported during the period of bankruptcy administration?
- Has all of the income from abandoned assets been included in the partnership return?

- Have there been asset transfers within the year prior to filing the petition for bankruptcy protection?
- Does the Schedules K-1 clearly and accurately reflect the nature and amount of income loss and changes in capital?
- Has a partnership interest been issued in exchange for debt?

Partner

- Has the partner included all Schedule K-1 income and loss?
- If a related partnership filed for bankruptcy, has the partner excluded income due to the partnership's filing for bankruptcy?
- Did the partner file for bankruptcy?
- Does the partner contend that he or she is insolvent?
- Are all assets included?
- Is the fair market value of the assets understated?
- Are debts overstated?
- Is any of the debt contingents?
- If COD has been excluded were the tax attributes reduced? See ***Firsdon v United States,*** 75 AFTR, 2d 95-368.
- If basis within a partnership was reduced, was the outside basis reduced?
- Were there any asset transfers within 3 months of the bankruptcy petition?
- Did the debtor reaffirm or voluntarily pay and debt?

Documents to Request

1. Last filed return prior to filing for bankruptcy
2. Bankruptcy petition and related schedules
3. All post petition returns filed
4. Calculations related to insolvency
5. Specific schedule of excluded income and attribute reductions
6. Related returns

Interview Questions

1. Explain any changes on the balance sheet
2. Was any debt forgiven during the tax years under audit?
3. Was the partnership or any partner in bankruptcy during the year prior to the audit to the present?
4. If yes, when was it filed?
5. Is it still open?
6. Do you know the bar date for creditors (IRS) to file a claim?

Supporting Law

Title 11 U.S.C. Bankruptcy
IRC section 108
IRC section 706
IRC section 752
IRC section 1001
IRC section 1017
IRC section 1398
IRC section 1399
IRC section 6231

Resources

- Internal Revenue Manual Section 4.3.2 - Collectibility Handbook
- Internal Revenue Manual Section 4.3.10 - Bankruptcy Handbook
- Publication 908 – Bankruptcy Tax Guide
- Bankruptcy Division Public Information Series, Administrative Office of the US Courts
- Collier's Bankruptcy Taxation
- American Bankruptcy Institute Website - www.abiworld.org
- Bankruptcy Court Websites - go through: www.legal.gsa.gov/

ISSUE: LOW INCOME HOUSING TAX CREDIT (IRC section 42)

The low income housing tax credit was enacted with respect to tax years after 1986 to promote affordable housing. Each state is annually allocated tax credits based on population. Through a competitive process, the states award their tax credits to qualifying projects based on housing needs. Ten percent of a state's annual credit allocations are set aside for projects that include ownership and on-going involvement of not-for-profit organizations. Generally, project developers form partnerships and sell limited partnership interests to investors to finance the development and operation of low-income housing projects. The projects are not expected to produce income for the investors. Instead, investors look to the credits, which will be used to offset their tax liabilities, as their return on investment.

To qualify for the low income housing credit, the units must be residential rental units rented to qualifying tenants and rent restricted. In order for a project to be awarded credits, the developer must commit to maintaining the project as low income housing for 30 years. For purposes of IRC section 42, the credit is taken over a 10-year period (credit period) and the property must be in compliance for 15

years (compliance period). One-third of the credit claimed each year is an "accelerated" credit since the credit period is 10 years and the compliance period is 15 years.

The credit is approximately 9 percent per year for new construction and 4 percent for rehabilitation or federally subsidized buildings. For example, if a building has a qualified basis of $1,000,000 and a 9 percent credit allocation, a $90,000 credit will be claimed in each of 10 years for total credits of $900,000 (if the property remains 100 percent low-income throughout the 15 year compliance period).

Form 8609, Low Income Housing Credit Allocation Certification, is the allocating document for a low income housing tax credit. It is issued by the state housing agency (or a sub-allocator) when the building is placed in service and must be signed by an authorized state official. There will be one Form 8609 for each building in a multi-building project. Part I is completed by the state and specifies the maximum qualified basis and credit as well as the date the building was placed in service. Part II is completed by the taxpayer in the initial year of the credit and contains certain irrevocable elections. A copy of the initial Form 8609 must be attached to the partnership return with respect to each year of the 15-year compliance period. The partnership must file a Form 8609, Schedule A, Annual Statement, which identifies changes to qualified basis and occupancy. A Form 8586, Low-Income Housing Credit, must also be included with the partnership return. It summarizes the Forms 8609, Schedule A, and should equal the total low income housing credit reflected on Schedule K of the partnership's Form 1065. The total credit is allocated to the individual partners on their Schedules K-1.

A partner whose ownership of low-income housing property is held only through a partnership will attach only a Form 8586 to his return to calculate credit limitations. A Form 8609 is not required to be attached by the partner.

Annually the owners of low-income housing projects submit certification reports to the allocating agencies. The agencies also monitor project compliance through periodic property inspections and tenant record reviews. Noncompliance is reported by the agencies to the IRS on Form 8823, Report of Noncompliance. The form is also used to report property dispositions. The Form 8823 is also used to file notices of corrections of noncompliance when the state agencies have determined that the owner remedied the item of noncompliance. The reports are filed with the Philadelphia Service Center.

If the number of low-income housing units decreases there is a corresponding recapture of the corresponding portion of the credit. If the number of units

maintained as low-income units falls below the minimum set aside (the minimum number of units that must be maintained as low-income units), then the entire amount of the credit claimed that year is disallowed (no current year credit and full recapture of the accelerated portion). Interest on the recapture of accelerated credits runs from the due date of the return upon which it was claimed.

If there is a disposition of a low-income property, full recapture of the accelerated portion of the credit is required unless the property is sold to a party who will maintain the property as low-income housing (and in compliance with IRC section 42). In such cases, the taxpayer can post a bond with the IRS. If a bond has been posted the taxpayer will file a Form 8693, Low Income Housing Credit Disposition Bond and will be able to provide documentation that the bond is in place throughout the remaining portion of the compliance period. (Note: as an alternative, the taxpayer can buy government securities. The documentation will be comparable to the bond documentation.) If the taxpayer recaptures the accelerated credits, it will be reported on Form 8611, Recapture of Low-Income Housing Tax Credit.

Examination Techniques

Contact your area low income housing coordinator if you are auditing a return initiating the low income housing credit and request the assistance of an agent trained in IRC section 42.

When inspecting a partnership with a low income housing tax credit:

1. Look for the Forms 8609 and see if the credits allocated are less than or equal to the credits claimed. The Form 8609 should indicate whether this is new or rehabilitated construction. The credit should be less than 9 percent of the fixed assets for new construction or 4 percent for rehabilitation.

2. Review any available depreciation schedule to determine what is included in the credit base. A cost incurred in the construction of a low-income housing building is includable in eligible basis if the cost is included in the adjusted basis of depreciable property subject to IRC section 168 and the property qualifies as residential rental property under IRC section 103 or depreciable property subject to IRC section 168 that is used in a common area.. For example, the cost of constructing a parking area would qualify under this test if made available to all tenants without cost.

3. Tour the property to ensure it exists and is well maintained.

4. Inspect the balance sheet to compare the costs of land and intangibles to the overall costs.

5. The date placed in service will indicate how far along the taxpayer is in the credit stream. If the balance sheet indicates a property disposition, is recapture reflected on the Schedules K-1? Asset locator services and the web may provide additional information with respect to transfers of ownership.

6. Consider reports of noncompliance filed by the state agency. Information can be obtained with the assistance of the coordinator.

Issue Identification

Auditing this issue will include, at a minimum, verification of the qualified and eligible basis (costs which are included in the computation of allowable credits), tenant qualifications, and whether rents were properly restricted. Issues in low income housing are:

1. No Form 8609 was issued by state agency:
   - If a credit is shown on the partnership return, make sure that there is an Form 8609 attached
   - Make sure that the Form 8609 was timely signed by a state official

2. The credits allocated do not match the credits claimed:
   - If the credits claimed are less than those allocated make sure that the percentage claimed is at least that shown in the minimum set aside election
   - If the credits claimed are more than the credits allocated they are not allowable. If the taxpayers spent more than originally anticipated they need to request and receive an additional allocation to claim credits

3. The minimum set aside was not timely met:
   - The project was not placed in service
   - The minimum set aside was not met by the end of the second year that a carryover allocation was made to a taxpayer
   - The taxpayer failed to maintain records

4. The first year credit is not properly calculated:
   - If the Form 8609 shows that this is the first year that a project was placed in service midyear then there should be only a part year credit

5. Qualified basis:
   - Developer's Fee - must be reasonable and for services actually rendered, must be noncontingent, related party rules apply
   - Land Costs - allocation between land and qualified basis

- Acquisitions Fees
- Syndication Costs
- Financing - Federal financing (direct or indirect), grants, contingent liabilities

6. Living Standards – health, safety, and building codes

7. Disposition – credit recapture or bonds

8. Tenants are not qualified – tenants must be income qualified, full time students are not qualified unless they meet exceptions, transient use, etc.

9. Rents not properly restricted – utility allowances, assisted services

Partnership Issues

1. Special Allocations
   - Special Allocations are permissible within limits - See Chapter 6

2. Recapture
   - If a partnership has 35 or more partners, the partnership is subject to recapture if applicable. The increase in tax will be allocated to the partners in the same manner as the partnerships taxable income for the year, IRC section 42(j)(5).

3. Tax Exempt Partners
   - If a project received an allocation based on the participation of a tax exempt entity, the entity must continue to participate for the entire 15 year compliance period
   - If there are special allocations then, the tax exempt use rules of IRC section 168 must be considered.

Partner-Level Issues

1. Partners are subject to basis, at-risk and passive activity loss rules
   - A loss from a low income housing partnership will reduce the partners basis but a low income housing credit will not.

2. Recapture
   - Disposition of partnership interest is a disposition of low income housing credits and subject to recapture. Exceptions: if there are more than 35 partners in the partnership, there is no recapture unless the partnership has elected out of the recapture responsibility (IRC section 42(j)) or there is a deemed termination of the partnership.
   - A partner is not subject to recapture until he or she disposes of more than 33-1/3 interest in a partnership. Revenue Ruling 90-60.

3. Passive Activity Losses
   - A partner must actively participate to qualify for the $25,000 offset allowed for rental losses. A limited partner will not qualify.
     Losses from low income housing partnership interest belong on line 2 of Form 8582 for partners subject to passive activity loss rules.
   - A partner may claim a tax deduction equivalent to the $25,000 deduction without regard to participation. This is a credit of $25,000 multiplied by the taxpayer's tax rate.
   - The partner may not claim a $25,000 offset for a rental loss and a $25,000 credit equivalent unless he has passive income.
   - The $25,000 offset for a rental loss is before the credit
   - There is no phase out of the credit due to modified AGI
   - The credit is not allowable on property disposition but may only be used when there is passive income

Supporting Law

IRC section 42 and related regulations
IRC section 704
IRC section 168
IRC section 469

Resources

MSSP Guide for the Low-Income Housing Tax Credit (TPDS No. 89018M)

ISSUE: CAPTURING "PHANTOM" GAIN IN ZOMBIE PARTNERSHIPS

Sometimes a partnership will attempt to avoid ***Tufts*** gain on disposition of property by sale or foreclosure by claiming that the liability of the partnership still exists. Without the relief of liability no gain is required to be recognized. Partnerships which are no longer actively engaged in business but which still wander aimlessly about shedding tax benefits or postponing gain are called "Zombie Partnerships."

How to Recognize a Zombie

A Zombie partnership has debt, a large negative capital account, and very little in the way of assets or economic activity. Sometimes the Zombie balance sheet will show negative assets and no liabilities; this occurs where the partnership was a lower tier investor in another partnership that actually owned property and had debt which was allocated to the partnership you are examining. If there is no income or loss allocated to your partnership, chances are that the property has been sold and the other partnership no longer exists.

A more unusual type of Zombie partnership still shows significant rental activity and property ownership, but close inspection of the rental schedule and balance sheet reveals that the rental loss is covered by depreciation and interest accruals. This can occur where the property is acquired by using "wraparound" financing and interest is payable from cash flow. This can be illustrated by the following example.

Example 8-11

Buyer Partnership agrees to purchase a shopping center from Seller for $125 million dollars by paying $35 million in cash and $90 million in the form of a contract for deed at 12 percent interest. The property is subject to a $45 million First Mortgage with interest at 8 percent and the contract provides that under no circumstances can the contract payments be less than the amount required to amortize the First Mortgage. After making the minimum payments, the buyer must pay all remaining cash flow as interest, with any unpaid interest added to the outstanding balance and accruing interest at 12 percent. All payments over the minimum amount are applied first to the earliest accrued interest. In the early years it is possible to argue that Buyer can profit if sales and rents at the shopping center increase enough to eventually cover the interest payments. By year 15 however, the annual accruals for interest are greater than gross rents and the balance of previously accrued and unpaid interest is greater than the original $90 million principal balance. At this point it is clear that Seller bears the risk of loss if the value of the shopping center declines and Buyer has an option to acquire the property in the unlikely event that it appreciates sufficiently to cover the mortgage principal and (rapidly increasing) accrued interest. Since the entire cash flow from the property is paid to the Seller as interest and as a cash basis taxpayer none of the accrued interest is reported, only the *tax benefits* of ownership were transferred and not the economic benefits of ownership.

These situations also occur in older HUD mortgages on Low Income Housing and are not as rare as one might think. When the property is sold, the amount of the accrued interest is included in the "wraparound" financing for the buyer to depreciate, but the seller does not include it in income, claiming that they have contingent liability to HUD in the event of default by the buyer; that is, the seller becomes a Zombie.

In the case of a Zombie Partnership, the Duty of Consistency prevents the taxpayer from claiming that the liability was in fact extinguished in a prior (expired) year and that the gain does not belong in the current year. If the liability does not exist at the end of the year under examination it will be treated as an IRC section 752(b) distribution for that year. If the taxpayer takes the position that the liability did not exist at the beginning of the year either, care must taken to ensure that each and

every condition necessary for the application of the doctrine exists in your case. See ***Spencer Medical Associates***, TC Memo 1997-130.

In the case of operating partnerships where the interest accrual is enormous relative to the rents collected, as in the example described above, IRC section 752(c) provides that a liability to which property is subject shall, to the extent of the fair market value of such property be considered as a liability of the owner of the property. The key is the fair market value of the property. If the liability greatly exceeds the value of the property, the liability for the current interest accrual will not be considered a "liability of the owner of the property;" as a result, the partners will have no remaining basis to claim losses in the current or future years.

Where the mortgage greatly exceeds the value of the property, no interest or depreciation charges with respect to that loan are allowable, since to be included in basis, the note must reflect a genuine debt (***Estate of Franklin v. Commissioner*****,** 544 F.2d 1045 (9th Cir. 1976). In determining whether there is likelihood of repayment, the courts look to the facts and circumstances of each case (***Waddell v. Commissioner***, 841 F. 2d 264 (9th Cir. 1988). The courts do not intend to require an appraisal of all rental property every year and therefore these rules are to applied only in egregious cases.

Of course, if there is no reasonable likelihood that the interest will actually be paid, it does not meet the requirements for accrual under IRC section 461 (the all events test) and should be disallowed. This is consistent with the Code and will eliminate the need to argue in some future year as to whether ***Tufts*** or IRC section 111 applies. If it is not a genuine liability, it is not includable in the sales price. On disposition of the property this argument is not available to the taxpayer since the Duty of Consistency prevents them from claiming that the debt lacks economic substance.

Examination Techniques

Issue Identification

1. The partnership shows little or no economic activity and has a substantial negative capital account. This may indicate that the property was disposed of in a prior year without recognition of the entire gain. The partnership may have a negative asset on the Other Investments line indicating that it was a tiered partnership.

2. Be aware if a partnership reports rental income and expense that results in a very large loss, no capital contributions are made, and there is a large negative capital account. Only where interest expense accruals are very large in relation to rental income can a case be made that the partnership is a Zombie.

Documents to Request

1. Partnership Agreement and all amendments.
2. Copies of all loan documents including, but not limited to promissory notes, deeds of trust, mortgages, loan payment histories, loan guarantees and/or loan indemnification agreements.
3. If the partnership is tiered, copies of that partnership agreement and all amendments, together with all Schedules K-1 ever received.
4. Copies of all purchase and sales documents and settlement sheets.
5. Real Estate Tax statements (to show ownership and value).
6. Verification, as of year end, of the amount and type of liability supporting the negative capital account.

Interview Questions

1. What happened to partnership assets and when did it occur?
2. What is the basis for your claim that the partnership was still liable for the debt shown on the balance sheet/Schedule K-1?
3. To what extent do these liabilities include accruals for interest and taxes?

Supporting Law

General Rule-IRC section 752(b)
Secondary Rule- IRC section 752(c)

IRC section 752(b) provides that any decrease in a partner's share of the liabilities of the partnership *** shall be considered as a distribution of money by the partnership to the partner.

***R. H. Stearns Co v. United States,* 291 U.S. 54 (1934)**
This is the Supreme Court case on which the judicial doctrine of the "Duty of Consistency" is founded. This doctrine holds that the taxpayer may be bound in the current year to a prior error or misrepresentation when the following circumstances are met:

1. The taxpayer made a representation or reported an item for Federal income tax purposes in one year,
2. The Commissioner acquiesced in or relied on that representation or report for that year, and
3. The taxpayer attempts to change that representation or report in a subsequent year, after the period of limitations has expired for the year of the representation or report, and the change is detrimental to the Commissioner.

***Spencer Medical Associates v. Commissioner* (T.C. Memo 1997-130) (*Aff'd*, 4th Cir 7/98), 98-2 USTC 50, 578**
The application of this doctrine to burned out tax shelters is illustrated by this case. The taxpayer unsuccessfully contended that partnership notes used to support claimed deductions in prior years were invalid. The Court held that since the partnership had treated them as valid in the intervening year returns, they were

bound by the duty of consistency. When the duty of consistency applies, the Commissioner may proceed as if the representation or report on which he relied continues to be true, although, in fact, it is not.

ISSUE: SECTION 263A – UNIFORM CAPITALIZATION

Uniform capitalization rules apply to partnerships involved in real estate development and construction. Also, the rules apply to partnerships that may self-construct assets. For example, IRC section 263A requires the capitalization of the costs of a new office building built by a law firm or construction of leasehold improvements to real property by any business.

This section does not attempt to explain all of the rules and exceptions. A very comprehensive guide entitled **Section 263 A Uniform Capitalization** is available from Multimedia Production Division (Go to IRS Intranet Home Page and click on Forms/Pubs/Docs and Forms/Pubs/Products Repository). The guide includes a detailed discussion of IRC section 263A with references to the Code, regulations, and other appropriate citations. It also includes a six-step approach to an IRC section 263A issue. In addition the guide contains five appendices that provide various research sources as follows:

A. Court Cases
B. Notices and Announcements
C. Letter Rulings and Technical Advice Memoranda
D. Articles
E. Contacts

IRC section 263A requires that certain direct and indirect costs (including interest under IRC section 263A(f) and taxes) be capitalized into the cost of real or tangible personal property produced by the taxpayer and real or personal property acquired for resale. It may require capitalization of interest incurred by the partners, IRC section 263A(f)(2)(C).

IRC section 263A is a timing provision. IRC section 263A does not create or disallow deductions; it merely changes the timing of the deduction. In other words one must determine whether the costs would, but for IRC section 263A, be otherwise deductible. A cost that is not otherwise deductible may not be allocated to property produced or acquired for resale.

Pre-production Costs

If property is held for future production or if it is reasonably likely that the property will be produced at a future date, pre-production costs must be capitalized. Costs of storing raw materials and carrying costs of realty held for development must be capitalized.

Real estate developers "*** must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed." See Treas. Reg. section 1.263A-2(a)(3)(ii).

In addition other pre-production expenses, including but not limited to expenses related to the following must be capitalized:

- Engineering and design
- Architectural plans
- Securing building permits
- Obtaining zoning variances
- Meetings with government officials
- Feasibility, environmental impact, and engineering studies

Interest Capitalization — IRC section 263A(f)

IRC section 263A(f) provides rules for the capitalization of interest expense during the production period of designated property. See Treas. Reg. section1.263A-8(b)(4)(I) for the De minimis "exception". Real property and tangible personal property (that meets certain classification thresholds) is considered designated property. IRC section 263A(f)(4)(B) defines the production period as beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or is ready to be held for sale. Generally, the production period begins when physical activity is first performed. For example, the clearing of raw land, grading, excavation of foundations, etc.

Interest that is capitalized is considered part of the cost of the property produced. It is recovered through cost of goods sold, depreciation, amortization, etc.

Interest is capitalized under the "avoided cost" method. Interest expense directly attributable to production expenditures with respect to such property (traced debt) and interest expense on any other debt to the extent that the taxpayers interest costs could have been avoided if production expenditures had not been incurred (non-traced debt) is required to be capitalized. See IRC section 263A(f)(2)(A).

Example 8-12

Facts:
X is constructing a building. X borrowed $600,000 at 8 percent, which can be traced to the construction of the building. X's only other debt was a $700,000 loan at 6 percent interest, which cannot be traced to the construction of the building.

Analysis:
The building is real property and constitutes an entire unit of designated property. The accumulated production expenditures are $1,000,000. The $600,000 loan is traced debt. Interest of $48,000 ($600,000 x 8 percent) must be capitalized with respect to the traced debt. The excess expenditure amount is $400,000 (Accumulated production expenditures of $1,000,000 less traced debt of $600,000). Thus, $400,000 of the $700,000 loan is non-traced debt. Interest of $24,000 ($400,000 x 6 percent) must be capitalized with respect to the non-traced debt. Thus, X must capitalize interest in the amount of $72,000 ($48,000 interest on traced debt plus $24,000 interest on non-traced debt).

Interest capitalization requirements (including the "avoided cost" method) apply to partnerships and other flow-through entities (IRC section 263A(f)(2)(C). The requirements are applied at the partnership level first and then at the partner level, except as provided in the regulations. In other words, if the partnership does not have debt equal to or in excess of the accumulated production expenditures, then interest expense incurred by partners may have to be capitalized.

Change in Method of Accounting

If it is determined that a taxpayer is not capitalizing interest and expenses as required by IRC section 263A, then the taxpayer's accounting method should be changed (IRC sections 481, 446, and related regulations).

Examination Techniques

A thorough explanation of examination techniques is included in **Section 263A Uniform Capitalization**.

Issue Identification

1. Other deductions claimed on the partnership return might be costs that are required to be capitalized.

2. Taxes claimed on the partnership return may include real estate taxes related to the development of real property.

3. If interest expense is claimed on the partnership return, it may have to be capitalized.

Documents to Request

1) Partnership Agreement and all amendments.
2) Copies of all loan documents including, but not limited to promissory notes, deeds of trusts, and mortgages.
3) All workpapers, schedules, and documents used to determine amount of interest expense deduction
4) Invoices, receipts and all other documents for "Other" Deductions (consultants, architects, engineers, lawyers, etc.) and real estate taxes.
5) Settlement sheets and other documents related to the purchase of real property.
6) Construction and architectural contracts.
7) Other documents may have to be requested for deductions claimed that appear to be subject to capitalization.

Interview Questions

1. Did the partnership develop any real estate during the year?
2. Did the partnership acquire any real property during the year or in prior years? If yes, what was the purpose for acquiring the property, what was the purchase price, and what is the location of the property?
3. Did the partnership deduct any costs related to the acquisition and development of real property? If yes, what was the type and amount of the cost?
4. Question the partnership on the purpose of deductions claimed for architectural fees, consultants, engineers, etc.
5. How did the partnership determine its interest expense deduction?
6. Refer to the guide entitled **Section 263A Uniform Capitalization** for leads on other possible interview questions.

Supporting Law

IRC section 263A and related regulations

See Treas. Reg. section 1.263A-10 for a series of comprehensive examples of the uniform capitalization rules being applied to various real estate development fact situations.

***Von-Lusk v. Commissioner*, 104 T.C. 207**
Real estate development limited partnership was required to capitalize pre-production costs (real estate taxes, meetings with government officials, costs of obtaining building permits and zoning variances, costs of negotiating permit fees, costs of performing engineering and feasibility studies, drafting and architectural plan costs, etc.)

***Lee D. Hustead*, T.C. Memo 1994-374**
Costs incurred to challenge zoning of property were required to be capitalized. Also, see ***Lee D. Hustead, et.ux v. Commissioner***, 76 AFTR 2d Par. 95-5112, and **Lee D. Hustead, et. Ux. v. Commissioner**, T.C. Memo 1997-205-expenses of challenging the constitutionality of local zoning ordinances were required to be capitalized.

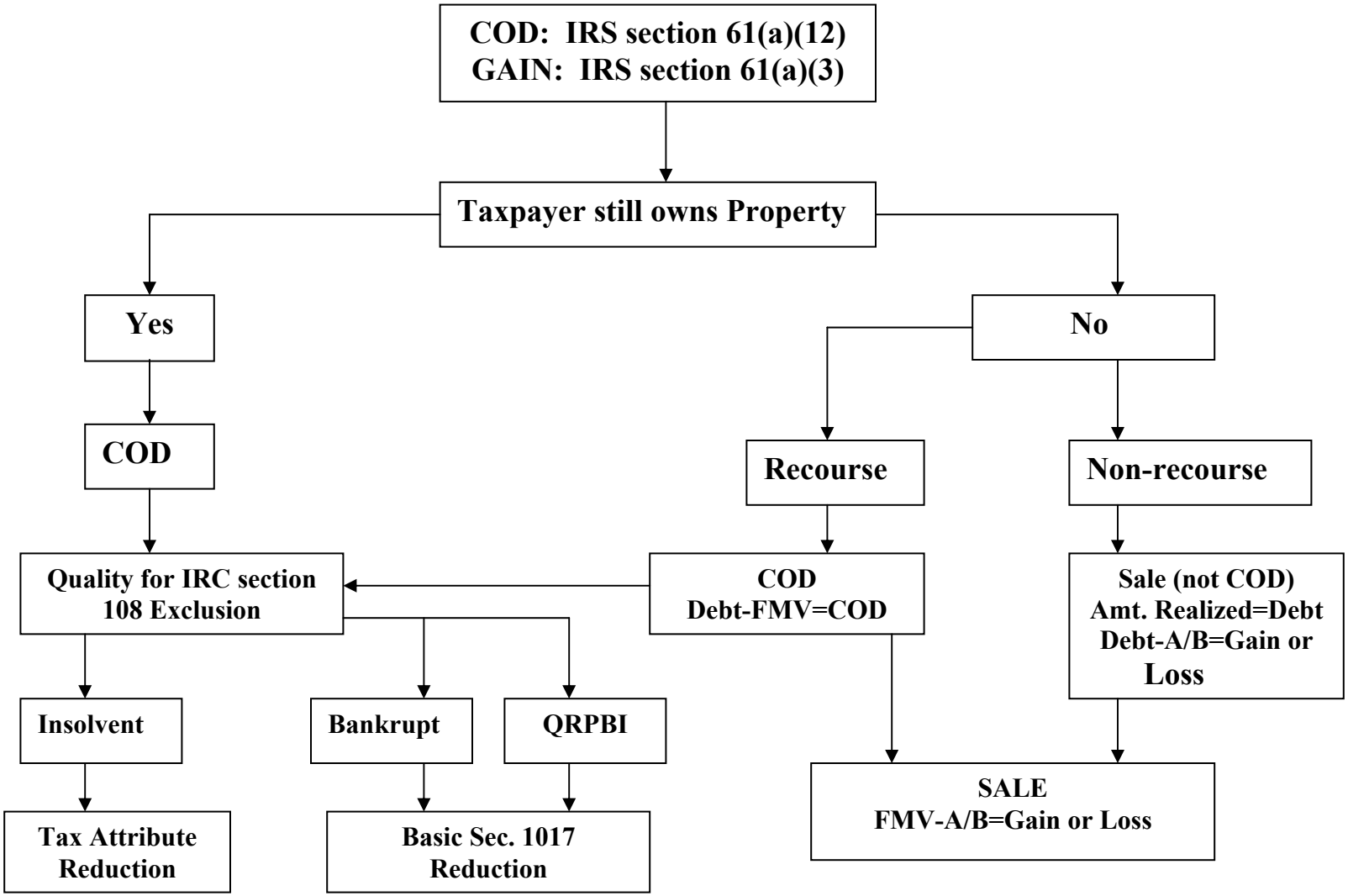
***John J. Reichel v. Commissioner*, 112 T.C. 14**
Real estate developer purchased land that was never developed due to adverse economic conditions. Court required capitalization of real estate taxes even though developer incurred no development costs like taxpayer in ***Von-Lusk, supra.***

Resources

Section 263A Uniform Capitalization, Document 10822 (Rev. 6-98), Catalog No. 25981E

You may also contact the Technical Advisor for Uniform Capitalization.

Exhibit 8-1


COD: IRS section 61(a)(12)
GAIN: IRS section 61(a)(3)
Taxpayer still owns Property
Yes
No
COD
Recourse
Non-recourse
Quality for IRC section 108 Exclusion
COD Debt-FMV=COD
Sale (not COD) Amt. Realized=Debt Debt-A/B=Gain or Loss
Insolvent
Bankrupt
QRPBI
SALE FMV-A/B=Gain or Loss
Tax Attribute Reduction
Basic Sec. 1017 Reduction

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Chapter 9

Tax Shelters

INTRODUCTION

Although tax shelters are often referred to as "corporate tax shelters," many of these shelters involve the abuse of partnerships. In recent years, there has been a continuous growth of the use of partnerships in tax shelters.

Several steps have been taken to address tax shelters and the abuse of the partnership entity. Treas. Reg. section 1.701-2, proposed in 1994 and finalized in 1995, provides two anti-abuse tests for partnerships. In February 2000, Treasury and the Internal Revenue Service issued temporary and proposed regulations under IRC sections 6011, 6111, and 6112 that imposed new disclosure, registration, and list maintenance requirements with respect to certain tax shelters. These regulations were subsequently modified in August 2000 and August 2001. Prop. Treas. Reg. section 1.6011-4T requires corporate taxpayers who have participated in a reportable transaction to attach a disclosure statement to certain tax returns. While this reporting requirement applies to corporate taxpayers, the reportable transactions may involve the use of partnerships. Prop. Treas. Reg. section 301.6111-2T requires promoters to register certain tax shelters by filing a Form 8264. Prop. Treas. Reg. section 301.6112-1T requires any person who organizes or sells any interest in a potentially abusive tax shelter to maintain a list identifying each investor.

If disclosure, registration, and/or list maintenance is required under these regulations, the transaction is not per se abusive, unless it is a listed transaction. Notice 2001-51, 2001-34 I.R.B. 190, identifies listed transactions for purposes of Prop. Treas. Reg. section 1.6011-4T and Prop. Treas. Reg. section 301.6111-2T. Some of these transactions may involve the use of partnerships. Additionally, the Office of Tax Shelter Analysis was established in 2000 and is responsible for monitoring abusive tax shelters.

This chapter will cover:

- Corporate Tax Shelter Characteristics
- Office of Tax Shelter Analysis
- Tax Shelter Disclosure
- Partnership Anti-Abuse Regulations
- Sham Partnership/Sham Partners
- Judicial Doctrines

OFFICE OF TAX SHELTER ANALYSIS

The Office of Tax Shelter Analysis maintains a Tax Shelter Hotline, reviews Tax Shelter Registrations, and manages a staff of Technical Advisors who are responsible for various types of abusive transactions.

The Tax Shelter Hotline was established to provide initial guidance when an examiner believes that a potential shelter has been uncovered in an audit. The Hotline is manned by an experienced examiner who can direct you to applicable Notices, court cases, and regulations that might pertain to your situation. You may also be directed to the responsible Technical Advisor who is assigned the "product."

Tax Shelter Registrations are filed with the Ogden Service Center. A team coordinated by OTSA makes periodic reviews of filed registrations. Penalties under IRC section 6111(d) can be imposed on promoters who fail to register in accordance with the regulations.

Technical Advisors have been selected to coordinate many of the transactions that are being marketed by shelter promoters. In some instances, more than one Technical Advisor is assigned to a transaction, such as both a Financial Products Technical Advisor and a Partnership Technical Advisor.

How to contact the Office of Tax Shelter Analysis:

Hotline Telephone: (202) 283-8740
Facsimile: (202) 283-8354

Address: Internal Revenue Service
LM:PFTG:OTSA
Office of Tax Shelter Analysis
Mint Building M3-320
1111 Constitution Avenue, NW
Washington, DC 20224

Email: irs.tax.shelter.hotline@irs.gov
Intranet: http://lmsb.irs.gov/hq/pftg/otsa/index.htm

TAX SHELTER DISCLOSURE

Registration of Tax Shelters

IRC section 6111 requires any tax shelter organizer to register certain tax shelters not later than the day on which the first offering for sale of interests in such tax shelter occurs. Any person claiming any tax benefit by reason of a tax shelter must include the identification number assigned to such tax shelter on his return.

Confidential Corporate Tax Shelters

IRC section 6111(d) concerning "certain confidential arrangements treated as tax shelters" was added to the Code in 1997. Prop. Treas. Reg. section 301.6111-2T implements IRC section 6111(d). It requires that promoters register any entity, plan, arrangement or transaction by their promoters which meets the following three requirements:

- a significant purpose of the structure is the avoidance or evasion of Federal income tax for a direct or indirect participant which is a corporation
- the transaction is offered under conditions of confidentiality
- the shelter promoters may receive fees in excess of $100,000 in the aggregate

All sales of confidential corporate tax shelters taking place after February 28, 2000, must be registered by filing a complete Form 8264, Application for Registration of a Tax Shelter. The penalty for failing to register is the greater of $10,000 or 50 percent of the promoter's fees. If it can be shown that the nondisclosure was intentional, the promoter's failure to register penalty is 75 percent of the promotion fees.

Tax Shelters in General: For registration purposes, arrangements or transactions which are not confidential must still be registered if they meet the definition of "tax shelter" as defined by IRC section 6111(c). For this purpose, a tax shelter is any investment which meets the following two conditions set forth in IRC section 6111(c)(1) and (2):

1. The first requirement concerns the "tax shelter ratio," a term defined in IRC section 6111(c)(2). In general, the tax shelter ratio is the ratio of the aggregate amount of deductions potentially allowable to any investor to the amount of money contributed by the investor. If the ratio is greater than 2 to 1 (the available deductions are twice the amount contributed by the investor) as of the close of any of the first five taxable years, the investment will meet the first requirement. The close of the first of the five taxable years starts after the date the investment is offered for sale.

2. The second requirement is that the investment is required to be registered under a federal or state law regulating securities, is sold pursuant to an exemption from registration, or is a substantial investment. If the investment is sold pursuant to an exemption from registration, the state or federal agency must receive a notice of this exemption. An investment is substantial if the organizer expects to have five or more investors and if the aggregate that may be offered for sale exceeds $250,000.

Corporate Taxpayer Disclosure Statements

Corporate taxpayers who participate, directly or indirectly, in "reportable transactions" are required to file a disclosure statement with their corporate tax return. Indirect participation includes participation though a partnership. Prop. Treas. Reg. section 1.6011-4T(a).

Treas. Reg. section 1.6011-4T defines the term "reportable transaction" as:

- Listed transactions, **and**
- Other reportable transactions

In addition to being either a listed transaction or another reportable transaction, a reportable transaction must also meet the projected tax effect test in Treas. Reg. section 1.6011-4T(b)(4).

Listed Transactions: For corporate tax returns filed after February 28, 2000, a listed transaction is one which is the same as or substantially similar to a transaction that the IRS has identified by notice, regulation, or other published guidance to be a tax avoidance transaction. See Notice 2001-51, 2001-34 I.R.B.

A listed transaction will satisfy the projected tax effect test if the corporate taxpayer expects the transaction to reduce corporate tax by more than $1,000,000 in any single year, or $2,000,000 during any combination of taxable years in which the transaction is expected to reduce the federal tax liability.

Other Reportable Transactions: A transaction entered into after February 28, 2000, is considered to be a reportable transaction if it has at least two of the following five characteristics:

1. The taxpayer has participated in the transaction under conditions of confidentiality as defined in Treas. Reg. section 301.6111-2T(c).

2. The taxpayer has obtained or been provided with contractual protection against the loss of the intended tax benefits. This

includes the right to a full or partial refund of fees paid to a promoter or fees that are contingent on the taxpayer's successfully securing the transaction's projected benefits.

3. The transaction was promoted, solicited, or recommended to the taxpayer by one or more persons who received fees or other consideration in excess of $100,000, and such person's entitlement to such fees or consideration was contingent on the taxpayer's participation in the transaction.

4. The transaction produces or is expected to produce a book/tax difference of over $5 million in any taxable year.

5. The transaction involves a tax-indifferent party whose participation is intended to provide the taxpayer with benefits that could not otherwise have been obtained.

The projected tax effect test will be satisfied if the taxpayer reasonably expects the transaction to reduce Federal income tax by more than $5 million in any single taxable year or by a total of more than $10 million in any combination of years in which the transaction reduces tax.

Even if the transaction has two of the above five characteristics and meets the projected tax effect test, it will not be subject to the disclosure requirements if it meets any one of the following four exceptions:

- The taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and the taxpayer reasonably determines that it would have participated in the same transaction on substantially the same terms irrespective of the expected Federal income tax benefits. Treas. Reg. section 1.6011-4T(b)(3)(ii)(A).

- The taxpayer has participated in the transaction in the ordinary course of its business in a form consistent with customary commercial practice, and the taxpayer reasonably determines that there is a generally accepted understanding that the taxpayer's intended tax treatment of the transaction (taking into account any combination of intended tax consequences) is properly allowable under the Internal Revenue Code for substantially similar transactions. There is no minimum period of time for which such a generally accepted understanding must exist. In general, however, a taxpayer cannot reasonably determine whether the intended tax treatment of a transaction has

become generally accepted unless information relating to the structure and tax treatment of such transactions has been in the public domain (for example, rulings, published articles, etc.) and widely known for a sufficient period of time (ordinarily a period of years) to provide knowledgeable tax practitioners and the IRS reasonable opportunity to evaluate the intended tax treatment. The mere fact that the taxpayer may have received an opinion or advice from one or more knowledgeable tax practitioners to the effect that the taxpayer's intended tax treatment of the transaction should or will be sustained, if challenged by the IRS, is not sufficient to satisfy the requirements of this paragraph (b)(3)(ii)(B). Treas. Reg. section 1.6011-4T(b)(3)(ii)(B).

- The taxpayer reasonably determines that there is no reasonable basis under Federal tax law for denial of any significant portion of the expected Federal income tax benefits from the transaction. This paragraph (b)(3)(ii)(C) applies only if the taxpayer reasonably determines that there is no basis that would meet the standard applicable to taxpayers under Treas. Reg. section 1.6662-3(b)(3) under which the IRS could disallow any significant portion of the expected Federal income tax benefits of the transaction. Thus, the reasonable basis standard is not satisfied by an IRS position that would be merely arguable or that would constitute merely a colorable claim. However, the taxpayer's determination of whether the IRS would or would not have a reasonable basis for such a position must take into account the entirety of the transaction and any combination of tax consequences that are expected to result from any component steps of the transaction, must not be based on any unreasonable or unrealistic factual assumptions, and must take into account all relevant aspects of Federal tax law, including the statute and legislative history, treaties, administrative guidance, and judicial decisions that establish principles of general application in the tax law (for example, ***Gregory v. Helvering***, 293 U.S. 465 (1935)). The determination of whether the IRS would or would not have such a reasonable basis is qualitative in nature and does not depend on any percentage or other quantitative assessment of the likelihood that the taxpayer would ultimately prevail if a significant portion of the expected tax benefits were disallowed by the IRS. Treas. Reg. section 1.6011-4T(b)(3)(ii)(C).

- The transaction is identified in published guidance as being excepted from disclosure under this section. Treas. Reg. section 1.6011-4T(b)(3)(ii)(D).

Note: These exceptions do not apply to listed transactions.

Penalties

Prior to the Taxpayer Relief Act of 1997, the term “tax shelter” under IRC section 6662 for purposes of imposing the accuracy-related penalty meant a partnership or other entity, plan, or arrangement if **the principal purpose** was the avoidance or evasion of federal income tax. Effective for items with respect to transactions entered into after August 5, 1997, the definition of a "tax shelter" for purposes of IRC section 6662 was changed to be any

partnership or other entity, plan, or arrangement if **a significant purpose** is the avoidance or evasion of federal income tax. Thus, for penalty purposes, the definition of “tax shelter” became more encompassing.

There are no specific penalties for failing to file a disclosure statement for a reportable transaction. The failure to file a required disclosure statement, however, may have an impact on the taxpayer's ability to satisfy IRC section 6664 "reasonable cause and in good faith" defense to the IRC section 6662 accuracy-related penalty.

If any person who organizes or sells any interest in a potentially abusive tax shelter fails to maintain a list identifying each investor as required under Treas. Reg. section 301.6112-1T, the penalty that may be imposed is $50 per investor with a maximum penalty of $100,000 per calendar year. If a promoter fails to register a tax shelter as required under Treas. Reg. section 301.6111-2T, a penalty under IRC section 6707 may be imposed.

PARTNERSHIP ANTI-ABUSE REGULATIONS

Overview

The partnership anti-abuse regulations give the Service the ability to recast transactions which may comply with the literal language of the Code and regulations, but which produce tax results never contemplated by Subchapter K. Treas. Reg. section 1.701-2 provides two anti-abuse tests for partnerships. These regulations were proposed in 1994 and finalized in 1995. If the results of a transaction are inconsistent with Subchapter K, and a principal purpose of the transaction is the reduction of tax liability, the Commissioner has the authority to undertake a variety of actions to achieve tax results consistent with the intent of Subchapter K.

Coordination

Based on Announcement 94-87, 1994-27 I.R.B. 124, and the preamble to T.D. 8588, any application of this regulation is required to be coordinated with Compliance and the Office of Chief Counsel to provide fair and consistent treatment of taxpayers when applying the regulation. If the examiner believes that the anti-abuse regulations are applicable, the examiner should contact either an LMSB Partnership Technical Advisor or SBSE Partnership Issue Specialist as soon as possible. The Technical Advisor or Issue Specialist will then coordinate the issue with the Office of Chief Counsel. The examiner should not raise the issue with the taxpayer until clearance has been obtained from the Technical Advisor or Issue Specialist.

Effective Dates

While paragraphs (a), (b), (c), and (d) are effective for all transactions involving partnerships that occur on or after May 12, 1994 ("partnership anti-abuse"), paragraphs (e) and (f) are effective for all transactions involving a partnership that occur on or after December 29, 1994 ("abuse of entity").

Intent of Subchapter K

Treas. Reg. section 1.7014-2(a) states that the intent of Subchapter K is to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. The "conduct of joint business" does not include business activities engaged in solely for tax avoidance purposes.

Implicit in the intent of Subchapter K are the following:

- The partnership is bona fide
- Each partnership transaction or series of transactions must be entered into for a substantial business purpose

- The form of each transaction must be respected under substance over form principles
- The tax consequences must accurately reflect the partners' economic agreement and clearly reflect the partners' income

Recognizing that some provisions of Subchapter K produce tax results which do not properly reflect income, (such as the value equals basis rule found in Treas. Reg. section 1.704-1(b)(2)(iii)(c)), the regulations state that the clear reflection of income requirement will be met if the tax results are "clearly contemplated" by the Subchapter K provision. Treas. Reg. section 1.7014-2(a)(3).

Factors Indicating Abuse

Whether or not a particular partnership or partnership transaction was used to substantially reduce taxes in a manner inconsistent with the intent of Subchapter K depends on all the facts and circumstances. The regulations provide a nonexclusive list of factors that may indicate a disregard for the intent of Subchapter K (Treas. Reg. section 1.701-2(c)):

1. The present value of the partners' aggregate federal tax liability is substantially less than it would have been if the partners had owned the partnership's assets and conducted the partnerships activities directly.

2. The present value of the partners' aggregate federal tax liability is substantially less than it would have been if purportedly separate transactions were integrated into a single transaction.

3. One or more partners who are necessary to achieve the claimed tax results have either a nominal interest in the partnership, are substantially protected from any risk of loss, or have little or no participation in partnership profits other than a preferred return which is essentially a payment for the use of capital.

4. Substantially all of the partners are related to one another, directly or indirectly.

5. Partnership items are allocated according to the literal language of the partnership allocation regulations (Treas. Reg. sections 1.704-1 and 1.704-2) but with results that are not in harmony with the underlying purpose of IRC section 704(b), which is that tax allocations should reflect the allocation of economic income or loss. Partnerships which specially allocate income to tax-neutral partners should be scrutinized. Tax-indifferent partners may include:

   - A foreign person
   - An exempt organization
   - An insolvent taxpayer

- A taxpayer with unused net operating losses, capital losses, or foreign tax credits

6. The contributor or a related party substantially retains (directly or indirectly) benefits and burdens of ownership of property contributed to a partnership.

7. The benefits and burdens of ownership of partnership property are substantially shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed.

There are 11 examples included in the regulations. Three of them (Examples 7, 8, and 11) illustrate situations in which the use of the partnership was considered inconsistent with the intent of Subchapter K. Example 7 illustrates a lease stripping transaction. Example 8 illustrates the use of a partnership to duplicate a tax loss through the absence of an IRC section 754 election. Example 11 illustrates the use of a partnership to artificially shift basis from an asset the partner plans to hold, to another asset the partner plans to sell at a loss after receiving the assets in liquidation of his partnership interest.

Authority to Recast Transactions

If a partnership transaction substantially reduces the present value of the partners' aggregate federal tax liability in a manner that does not conform with the intent of Subchapter K, the Commissioner has the authority to recast the transaction for federal tax purposes.

To accomplish this, the Commissioner has the authority to:

- Disregard the partnership in whole or in part
- Disregard one or more of the partners
- Change the method of accounting to clearly reflect the partnership's or the partner's income
- Reallocate items of income, gain, loss, deduction, or credit
- Otherwise adjust or modify the claimed tax treatment

Documents to Request

1. Partnership agreement
2. Agreements between partnership and any partners
3. Any original documents, correspondence, or minutes of meetings which will shed light on the business purpose of the partnership or the business purpose of any of the partnership's transactions

Interview Questions

Interview questions and requests for documents should be crafted to answer the following types of questions:

1. Why was the partnership formed? What is its business purpose?
2. If the partnership was ostensibly formed as a joint enterprise for profit, how is the profit to be derived? Does it make good business sense that the parties would have joined together with a profit motive?
3. What did each partner contribute? What did each partner take away?
4. Are the partners subject to entrepreneurial risk? Do any agreements remove one or more partners' economic risk of loss? Is any partner accorded a preferred or guaranteed return on its contribution that indicates that it has been removed from the risks of the venture?
5. Are the benefits and burdens of ownership of partnership property shared among the partners? If not, which partner has control and responsibility for the partnership's property?
6. Are the partners related?
7. Are any of the partners tax neutral?

Supporting Law

Treas. Reg. section 1.7014-2.

Resources

Chapter 16, The Logic of Subchapter K, Laura E. Cunningham and Noel B. Cunningham (West Group, 2,000)

IRS Improves Partnership Anti-Abuse Reg., but Major Problems Remain, Richard M. Lipton, *Journal of Taxation,* March 1995

Partnership Anti-Abuse Rule: Dirty Minds Meet Mrs. Gregory, Lee A. Sheppard, *Tax Notes* 295, 296 July 18, 1994

The Partnership Anti-Abuse Reg: A Reasonable Step in the Right Direction, Daniel Halperin, 64 *Tax Notes* 823 August 8, 1994

The Appropriateness of Anti-Abuse Rules in the U.S. Tax System, Frank V. Battle Jr., *The Tax Lawyer,* Spring 1995

Sanctifying the Smell Test: Some Thoughts on the Final Partnership Anti-Abuse Regulations, J.D. Dell, *Journal of Real Estate Taxation*, Summer 1995

The following documents discuss the potential application of the anti-abuse rule:

- FSA 200134002
- FSA200118005
- FSA 200015005

- Notice 2000-44
- FSA 2000026009
- FSA 199936011
- 1999 FSA LEXIS 386
- 1998 FSA LEXIS 315
- 1998 FSA LEXIS 356
- 1998 FSA LEXIS 337
- 1998 FSA LEXIS 276
- 1997 FSA LEXIS 208
- 1996 FSA LEXIS 177
- 1995 FSA LEXIS 192

ECONOMIC SUBSTANCE OF PARTNERSHIPS AND TRANSACTIONS

A Partnership is defined as a business entity that is not a corporation (as defined under Treas. Reg. section 301.7701-2(b)) or a trust (as defined under Treas. Reg. section 301.7701-4) and that has at least two members. Treas. Reg. section 301.7701-(c)(1). The entity's status under state law does not determine its characterization for federal tax purposes

Courts have enumerated several factors indicative of a partnership, including:

- The agreement of the parties
- Conduct of parties in executing agreement
- Testimony of disinterested persons
- Relationship of the parties
- Capital contributions
- Control of income
- Other factors indicating intent

Other factors indicating intent are the contributions, if any, the parties have made to the enterprise, the right of each party to make withdrawals, the sharing of profits and losses, whether one party was the agent or employee of another, and whether the parties exercised mutual control and shouldered mutual responsibility for the success of the enterprise. For example, see ***Commissioner v. Culbertson***, 337 U.S. 733, 742 (1949).

JUDICIAL DOCTRINES

Overview

To be respected, a partnership and its transactions must have economic substance separate and distinct from the economic benefit achieved solely by tax reduction. If a taxpayer seeks to claim tax benefits, which were not intended by Congress, by means of transactions or entities that serve no economic purpose other than tax

savings, the doctrine of economic substance is applicable. Whether a transaction has economic substance is a factual determination. ***Frank Lyon Co. v. United States***, 435 U.S. 561 (1978), sets forth several factors indicating that a transaction has no economic substance. In sum, the application of the economic substance doctrine requires that one look beyond the form of the transaction to its substance.

When a transaction lacks economic substance, the form of the transaction is disregarded in determining the proper tax treatment of the parties to the transaction. A transaction that is entered into primarily to reduce taxes and that has no economic or commercial objective to support it is without effect for federal income tax purposes. ***Frank Lyon Co v. United States***, 435 U.S. 561 (1978); ***Rice's Toyota World Inc. v. Commissioner***, 752 F.2d 89, 92 (4th Cir. 1985) ***aff'g in part*** 81 T.C. 184 (1983).

Courts have also applied the economic substance doctrine to disregard partnerships. In ***ASA Investerings Partnership v. Commissioner***, 201 F. 3d 505, (D.C. Cir. 2000), ***cert. denied***, 531 U.S. 871 (2000), the D.C. Circuit, affirming the Tax Court, held that a domestic corporation did not enter into a valid partnership with several foreign corporations, through which the domestic corporation had sought to shelter capital gains. But see, ***Salina Partnership v. Commissioner***, T.C. Memo. 2000-352 (court refused to classify transitory partnership as a sham but upheld the Commissioner's determination on alternate grounds).

The economic substance doctrine is not intended to inhibit bona-fide business transactions. Factual development and industry knowledge is key in properly applying this doctrine. The doctrine could be thought of in these three ways:

- Sham in Fact ─ This involves a taxpayer claiming losses or deductions for a transaction or transactions that took place only on paper. In other words, the purported events never actually took place. In this case, the transaction would be disregarded for tax purposes.

- Sham in Substance ─ This is a transaction which actually took place, but which lacks the economic reality or substance that the form represents. In analyzing suspected substantive shams, several courts have focused on two related factors, business purpose and economic substance.

- Step Transaction Doctrine ─ This doctrine is based on the substance over form doctrine. This section will discuss these judicial doctrines.

Courts have expressed and interpreted the economic substance doctrine through numerous cases. The doctrine differs slightly depending on the applicable Circuit. The cases listed at the end of this section should be considered.

Step Transaction Doctrine

The step transaction doctrine is an expression of the substance-over-form doctrine. The step transaction doctrine collapses a series of transactions into a single transaction to determine the correct federal income tax consequences. Under the step transaction doctrine, "a series of transactions designed and executed as parts of a unitary plan to achieve an intended result *** will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation." ***FNMA v. Commissioner***, 896 F.2d 580, 586 (D.C. Cir. 1990), ***cert. denied***, 499 U.S. 974 (1991); see also ***Minnesota Tea Co. v. Helvering***, 302 U.S. 609, 613 (1938) ("[a] given result at the end of a straight path is not made a different result because reached by following a devious path").

In applying the step transaction doctrine, courts have applied three different tests:

- The end result test
- The mutual interdependence test
- The binding commitment test

Under the "end result" test, the transaction will be collapsed if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result. See for example ***King Enterprises, Inc. v. United States***, 418 F.2d 511, 516 (Ct. Cl. 1969). Under the "interdependence" test, the focus is on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." See for example ***Redding v. Commissioner***, 630 F.2d 1169, 1177 (7th Cir. 1980), ***cert denied***, 450 U.S. 913 (1981). Under the "binding commitment" test, a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to under-take the later step. See for example ***Commissioner v. Gordon***, 391 U.S. 83, 96 (1968)."

Documents To Request and **Interview Questions** must be specifically tailored to develop the true nature of the transactions under examination. In dealing with a possible sham transaction, the examiner should remember that the documents could be misleading and may not represent what actually took place.

Documents to Request

1. Partnership agreement
2. Agreements between partnership and any partners
3. Any original documents, correspondence, or minutes of meetings which will shed light on the business of the partnership

Interview Questions

Interview questions and requests for documents should be crafted to answer the following questions:

1. Who is responsible for carrying out the operational and management responsibilities of the partnership?
2. How are the administrative duties of the partnership handled, for example the bookkeeping and the payment of bills?
3. What are the partners' capital contributions?
4. What business risks do the partners assume?
5. Do partners bear any meaningful risk of financial loss?
6. Do all partners bear the burdens of ownership of the partnership property, or does one partner exercise control and responsibility over the property?
7. Will partners reap significant tax benefits if the partnership is respected for federal income tax purposes?

Supporting Law

Treas. .Reg. section 1.701-2

Commissioner v. Culbertson, 337 U.S. 733 (1949)

ASA Investerings Partnership v. Commissioner, 201 F. 3d 505 (2,000)

Merryman v. Commissioner, 873 F.2d 879 (5th Cir. 1989)

Duhon v. Commissioner, **T.C. Memo 1991-369**

Cirelli et al., v. Commissioner, **82 T.C. 335 (1984)**

Karr v. Commissioner, **924 F.2d 1018 (1991)**

Commissioner v. Tower, **327 U.S. 280 (1946)**

- **Sham In Fact**

  Saviano v. United States Court of Appeals 765 F.2d 643 (1985)

- **Business Purpose**

  Salina Partnership LP, FPL Group, Inc. v. Commissioner, T.C. Memo 2000-352

United Parcel Service of America, Inc. v. Commissioner, TC Memo 1999-268

Rice's Toyota World, Inc., 81 T.C. 184 (1983)

Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978)

- **Economic Substance**

  Economic Substance and Interest Deductions: A lack of economic substance may bar interest deductions under IRC section 163.

  Winn-Dixie Stores Inc. v. Commissioner, 113 T.C. 254 (1999),

  Goldstein v. Commissioner, 364 F.2d 734 (1966)

  Sheldon v. Commissioner, 94 T.C. 738 (1990)

  Knetsch v. United States, 364 U.S. 361 (1960)

  Corbin West Limited Partnership v. Commissioner, T.C. Memo 1999-7 No. 2203-97

- **Economic Substance and Capital Losses**

  ACM Partnership v. Commissioner, 157 F.3d 231,247 (3d Cir. 1998)

  Saba Partnership, et al. v. Commissioner, T.C. Memo 1999-359

  ASA Investerings Partnership v. Commissioner, 340 U.S. App. D.C. 55, 201 F.3d 505 (2000)

- **Step Transactions**

  Crenshaw v.United States, 450 F.2d 472 (1971)

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Chapter 10

International

(*Reserved)*

At the printing of this book, current information
On international issues was not available.

You may contact the International Technical Advisor
For Foreign Joint Ventures and Foreign Partnerships
In LMSB for further information.

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Chapter 11

Family Partnerships

INTRODUCTION

The original focus of Family Partnerships was to split income among family members. With the reduction in marginal tax rates, the emphasis has shifted to exploiting Family Partnership to reduce estate and gift tax.

One of the earliest, and most often cited, Supreme Court cases is ***Lucas v. Earl,*** 281 U.S. 111 (1930). The question presented was whether Guy Earl could effectively assign half of his compensation from the practice of law in 1921 and 1922 by contract to his wife. The validity of the contract was not questioned, but the Court held that the "fruits cannot be attributed to a different tree from that on which they grew." This has come to be known as the "Fruit of the Tree Doctrine" and has found application in many areas.

Subsequent taxpayers attempted to use the partnership provisions in lieu of a bare contract to attempt to divert income to family members and others. If successful, this stratagem would not only reduce income and employment taxes, it would completely circumvent transfer taxes. With the decline in income tax rates the principal focus in this area has become transfer tax avoidance.

ISSUE A: INCOME SHIFTING USING FAMILY PARTNERSHIPS

IRC section 704(e) is titled "Family Partnerships" but only one subsection applies to family members. Subsection (e)(1) provides that if any "person" acquires an interest in a partnership from any other "person" by purchase or gift, and if capital is a material income producing factor, then the person will be considered a partner whether they acquired the interest by purchase or gift. It provides a "safe harbor" with respect to partnerships in which capital is a material income-producing factor.

Subsection (e)(2) applies in the case of partnership interests acquired by gift. It provides that a donee's share of partnership income must be reduced to the extent of the donor's reasonable compensation for services rendered to the partnership.

Subsection (e)(3) is the one applicable to family members only and for this purpose, family means spouse, ancestors and descendents or trusts set up for their benefit. It

provides that partnership interests purchased from family members shall be treated as if created by gift.

Capital Is Not a Material Income-Producing Factor

Partnership income arises from services, capital or both. If capital is not a material income producing factor, and a partner performs no services, partnership income is allocated to the partner who performs the services. ***Lucas v. Earl***, and IRC section 704(e)(1) and (2).

Capital Is a Material Income Producing Factor

A determination of whether the interest was acquired by purchase or gift must first be made. If the partner is a family member, the purchase from another family member is treated as though it was acquired by gift. To be considered a partner for the purpose of receiving income allocations, the partner must be an owner in substance, and not just form. Treas. Reg. section 1.704-1(e)(2) describes the basic tests for ownership based on all the facts and circumstances. The following factors indicate that the donee is not a bona fide partner:

1. Donor retains direct control: This can be achieved through restrictions on distributions, rights to sell or liquidate, or retention of control over the assets of the business and retention of management powers inconsistent with normal (arms length) relations among partners.

2. Donor retains indirect control: The donor may control a separate entity that manages the partnership. The management entity may place restrictions that limit the ownership interest of the donee.

3. Donee does not participate in the control and management of the business, including major policy decisions. The degree of participation may indicate whether the donor has actually transferred an interest to the donee.

4. Partnership distributions actually are not actually made to the donee. If they are, the donee does not have full use or enjoyment of the proceeds.

5. The partnership conducts its business in the manner expected of a partnership. For example, it has a separate bank account, follows local law for business operations and treats the donee in the same way any other partner would be treated.

6. Other facts and circumstances may indicate the donor has retained substantial ownership of the interest transferred.

Treas. Reg. section 1.704-1(e) also addresses the issue of trustees as partners, ownership by minor children, and the use of limited partnerships. In the case of a limited partnership interest, does the limited partner have the right to sell, transfer, and liquidate without substantial restrictions? Does the donee-limited partner have the same rights as unrelated limited partners?

If the donee is not a bona fide partner the income must be allocated to the real owner of the partnership interest.

If the donee is a bona fide partner the donor still must be reasonably compensated for services rendered to the partnership and the donee's share of partnership income must be in proportion to donated capital. If these conditions are not met, there is reason to change the allocation.

Reducing income taxes by shifting income is not as important as it once was due to the reduction in tax rates and changes in rules for taxing unearned income of children. Income tax savings may contribute to the overall success of a family partnership set up to reduce transfer taxes as illustrated below.

ISSUE B: FAMILY PARTNERSHIPS AND TRANSFER TAXES

Estate and gift taxes are imposed on the transfer of property at death or the gifting during lifetime by a decedent or donor, respectively. The rates are graduated starting at 18 percent and rising to 55 percent on amounts over $3 million. The tax is imposed on the fair market value of the property involved, that is, the price a willing buyer and willing seller would agree upon.

A "unified credit" is provided to each taxpayer that reduces the actual amount of tax payable. The same amount of credit applies for both gift and estate taxes. The credit shelters a certain amount of otherwise taxable transfers. The equivalent amount of total property that is sheltered from tax by the unified credit is currently $675,000; that amount will rise to $1,000,000 by 2006. For this purpose "total property" applies to taxable gifts during lifetime and the remaining taxable estate at death.

For estate tax purposes prior taxable gifts are added to the value of the estate and the credit (plus any prior gift tax paid) is subtracted again. Gifts, and estate devises to spouses are fully deductible.

For gift tax purposes a married donor may elect to treat any gift as made one-half by each spouse. Because each donor is allowed an annual exclusion of $10,000 per

donee, gift splitting can result in a substantial amount of gifts being sheltered from taxation even before the use of the available unified credit.

Example 11-1

Fred Donor gives $50,000 in cash to his married daughter and her husband. He elects to "split" the gift with his own spouse, Mary. Fred is considered to have given $12,500 to child and $12,500 to child's spouse; Mary is considered to have done the same. Fred and Mary are each entitled to a $10,000 annual exclusion for each of their two gifts. (They need to file separate gift tax returns. Gift tax returns are required to be filed by the donors, not the donees, and there are no joint returns.) As a result, Fred has a $5,000 taxable gift and Mary has a $5,000 taxable gift. The resulting tax on each donor's $5,000 taxable gift is now sheltered by any remaining lifetime, unified credit.

In the past, an Estate and Gift Tax Attorney was permitted to examine and adjust all gifts made during a decedent's lifetime unless a gift tax had actually been paid. In that case the statute of limitations would run 3 years after the filing or due date as in the case of income tax returns. The Code was amended in 1997 to provide that (generally) the filing of a gift tax return would start 3-year statute of limitations regardless of whether the taxable gifts were fully sheltered by the unified credit. If the Service did not propose changes within that period, the numbers could not be adjusted later, for example, during the examination of an estate tax return. This provision has created an added burden on E&G Attorneys to take a harder look at gift tax returns.

The following example illustrates the use of valuation discounts and the unified transfer tax system. For purposes of this illustration, the taxpayer is considered to split each transfer with his own spouse and to make each annual gift to the donee and the donee's spouse.

Example 11-2

Fred Donor operates a successful retail sporting goods store worth $1,000,000. He has made all the money he needs and wants to pass the business to his two children and minimize the transfer taxes. He transfers the business to an LLC and begins making gifts of 10 percent each year to the donees. Upon his death in 6 years, his remaining 40 percent interest is included in his gross estate.

The gifts are discounted for lack of marketability and control. Lack of marketability applies to securities which are not publicly traded. A minority

interest has a lower fair market value since it has no control over management or distributions.

	Percent Transferred	Value	Value After Discount	Total Exclusions With Gift Splitting	Taxable Gift or Inheritance
1	10%	$100,000	$60,000	$40,000	$20,000
2	10%	$100,000	$60,000	$40,000	$20,000
3	10%	$100,000	$60,000	$40,000	$20,000
4	10%	$100,000	$60,000	$40,000	$20,000
5	10%	$100,000	$60,000	$40,000	$20,000
6	10%	$100,000	$60,000	$40,000	$20,000
Death	40%	$400,000	$240,000	0	$240,000
Totals	100%	$1,000,000	$600,000	$240,000	$360,000

It is important to note that after consideration of gift splitting, the annual exclusion, and the lifetime unified credit, transfers of partnership capital and any claimed discounts must be very substantial in order to justify a referral to Estate and Gift.

Examination Techniques

Where the partnership is engaged in an active business, determine that family members are compensated for services they perform for the partnership.

Carefully examine any allocations that are not proportionate to capital accounts when family members are partners. They must be based in that case on actual services provided.

Where younger family members' allocations are purportedly based on services, the same audit techniques used in corporate excess compensation cases can be used. However, since the tax effects are much smaller in the partnership context, you may not want to pursue the issue unless the amounts involved are substantial before pursuing this issue.

Where substantial gifts with significant claimed discounts are present the case should be referred to the Estate and Gift Tax group.

Issue Identification

1. Does the partnership contain the word "Family" in the name? Do the Schedules K-1 indicate a family relationship, such as same last names, trusts or same addresses?

2. How long has the partnership been in existence? Was it formed by the transfer of an existing business?

3. Is the partnership engaged in a trade or business, or is it an investment partnership? Is capital a material income-producing factor?

4. Does the return or partnership agreement show the recent addition of a related partner or an increase in capital of a younger family member? Do the Schedules K-1 indicate a transfer of capital from one family member to another?

5. Are there disproportionate allocations of income to family members? Are those providing services to the partnership adequately compensated?

Documents to Request

1. Partnership Agreements including any amendments.
2. Copies of any gift tax returns filed with respect to the transfer of any partnership interest or capital.
3. Calculations regarding any disproportionate income allocations

Interview Questions

1. Are any of the partners related by blood or marriage?
2. Were any interests in the partnership acquired by gift?
3. Were any interests acquired by purchase from a family member?
4. How are income allocations calculated?

Supporting Law

Lucas v. Earl, 281 U.S. 111 (S CT 1930). This case established the principle that the "fruit of the tree" must be taxed to the tree on which it grew.

IRC section 704(e) which provides rules consistent with ***Lucas*** for testing the allocation of partnership income, particularly where family members are partners.

Resources

Treas. Reg. section 1.704-1(e)(1) and (2)

Chapter 12

Syndicated Investment Partnerships

OVERVIEW

Syndicated Investment Partnerships as used in this guide are pools or syndicates formed, marketed, and managed by professional money managers. Since minimum investments start at $50,000 and it is not unusual for them to be higher than $500,000, the investor partners are generally wealthy individuals or families. Foundations and other tax-exempt organizations are also frequently investors.

Investment partnerships invest in stocks and bonds, both domestic and foreign, but sometimes concentrate on more exotic securities such as options, futures, forward contracts and other derivatives. Foreign currencies and related instruments are used and many are involved in arbitrage and straddles.

The partnership agreements generally provide that contributions and distributions can only be made as of year-end, although some funds provide quarterly valuations.

ORGANIZATION AND OPERATIONS

The most common type of organization involves an Investment Partnership where investments are made, the Managing Partner which is frequently a partnership composed of the Manager, Key Employees, family members, and the Management Company as illustrated in Exhibit 12-1.

The partnership agreement provides that the Investment Partnership shall pay a fee of 1 percent of assets to the Management Company for administrative expenses. In addition, the partnership pays an incentive fee to the Managing Partner that is generally 20 percent of net profits determined on the accrual basis using mark-to-market. (For Mark-to-Market, unrealized gains and losses are booked by adjusting the value of securities to FMV at year-end.) In the event of a loss, that amount is carried over and reduces profits in the next year for the purpose of determining the incentive fee.

Generally partners are admitted, and existing partners may make additional contributions or take distributions, only as of the first of the year. For example, a new partner would submit his or her cash contribution in December in order to be

admitted as a partner as of January 1 of the following year; the percentage interest they acquired is not determined until after the books are closed and net income for the year is computed. If the partner redeems his or her interest, the effective date is December 31, but he or she will probably not receive the proceeds until late January or early February of the following year when the actual amount of the capital account is determined. The partner will get a final Schedule K-1 for the year and report gain or loss on disposition in the next year, the year in which he or she received the cash proceeds from the disposition of his or her partnership interest.

ISSUE: SECURITIES TRADERS- ENGAGED IN A TRADE OR BUSINESS?

Since Investment Partnerships engage in substantial buying and selling of intangible assets, some partnerships claim that their activity constitutes "securities trading" such that they are engaged in a trade or business and not "investing." The distinctions between a "trader" and an "investor" for tax purposes are very significant and arose more than 50 years ago as a result of the Supreme Court decision in ***Higgins v. Commissioner,*** 61 S Ct. 475 (1941). There the Court stated that **"No matter how large the estate or how continuous or extended the work required may be, managerial attention to your own investments does not constitute a trade or business."**

At the time of ***Higgins***, only trade or business deductions were deductible and as a result taxpayers were denied **any** tax benefit for investment expenses. Congress considered that it was inequitable to deny any deduction for expenses that might increase taxable income, but were not willing to provide the same beneficial treatment as trade or business expenses. The result was the enactment of the predecessor to IRC section 212, which provided an itemized deduction for expenses incurred for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income. The enactment of IRC section 67 in 1986, combined with changes in the computation of Alternative Minimum Tax, made these deductions much less attractive to investors. The higher your income, the less attractive they are.

By claiming to be engaged in a trade or business, the Investment Partnership is entitled to claim their expenses as "Other Deductions" on Schedule K. (Some partnerships claim all expenses as Other Deductions on page 1 of Form 1065. This results in a large ordinary loss on line 1 of Schedule K since none of the income is on page 1.)

Prior court cases have held that traders on the floor of the Commodity Futures Trading Commission are entitled to capital gain or loss treatment on their trades.

The courts reasoned that since the traders were required to buy and sell at "open outcry," the futures were not held for sale to customers in the ordinary course of business; that is, without the ability to "mark up" futures, they did not meet the definition of inventory and, therefore, must be treated as capital assets.

Although the floor traders had only capital gain or loss and no ordinary business income, the courts have consistently found that their activity rises to the level of a trade or business. As a result, floor traders file Schedules C with only their expenses; all their income is on Schedule D. Congress has endorsed this treatment by enacting special legislation for these traders to provide them with Social Security coverage, special capital loss carrybacks, and pension plan deductions.

What Is a Securities Trader?

"Although the Supreme Court has yet to find a taxpayer properly characterized as a 'securities trader,' it is clear that such a 'businessman' exists, given the proper facts." (***Levin v. United States,*** 79-1 U.S.T.C. 9331) The standard applied by the lower courts to distinguish between an investor and a trader was first enunciated by the Tax Court in ***Liang v. Commissioner*** (23 T.C. 1040): "In the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. There is general agreement amongst the courts (***Moeller v. United States,*** 83-2 U.S.T.C. 9698 and ***Purvis v. Commissioner,*** 76-1 U.S.T.C. 9270) that the following factors are to be considered in determining whether a taxpayer is an investor or engaged in the trade or business of securities trading:

1. The taxpayer's intent- investment negates trader status.
2. Nature of the income from the activity- only short term gains qualify as trading income.
3. Frequency, extent and regularity of transaction- holding period can be critical.

Items 2 and 3 are objective (and quantitative) indicators of intent which are principally relied on. Taxpayers who mention "capital appreciation" or even "conservation of capital" do not prevail. Significant long term capital gains, and even dividends and interest, are strong indications of an investor and not a trader.

In one instance, the Court of Claims (***Mayer v. United States,*** 94-2 U.S.T.C. 50,509) took the position that a taxpayer who carefully selected money managers and farmed out a portion of his funds to each could not be considered a securities trader since he

did not actually make any purchase or sale decisions himself; "To claim a trade or business deduction, taxpayer must himself perform the activity characterizing the 'trade or business' citing ***Groetzinger*** (87-1 U.S.T.C. 9191). The Tax Court considered the same taxpayer for subsequent years and came to the same result based on holding period and frequency of trading. (***Mayer v. Commissioner***, TCM 1994-209)

The Supreme Court provided in ***Higgins*** that expenses related to real estate rental were deductible and that office and salary expenses could reasonably be allocated between investment and trade or business. Accordingly, even where it has been determined that a partnership is engaged in the trade or business of securities trading, care must taken to ensure that any portion of the partnership's activity or expenses that are properly allocable to investment should be separately stated.

ISSUE: INVESTMENT INTEREST EXPENSE DEDUCTIBLE ON SCHEDULE E?

Syndicated Investment Partnerships invariably advise their partners to adhere to the limitations on Investment Interest. Where the partnership has taken the position that they are engaged in the trade or business of securities trading, the partnership will advise the partners to claim the deductible portion of the interest expense on Schedule E. As explained below, this is not correct.

All investors in syndicated investment partnerships are limited partners since they do not wish to place their entire net worth at-risk. IRC section 163(d)(5)(A)(ii) provides that "property held for investment" includes any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. Treas. Reg. section 1.469-1T(e)(6) provides that securities trading is not a passive activity, regardless of whether it rises to the level of a trade or business. Thus, the interest expense is deductible only to the extent permitted by IRC section 163(d).

Since the treatment of non-corporate partners is dependent on the degree of participation of such partners, IRC section 163(d) could limit the deductibility of the interest expense associated with the partnership's trading activity for some partners and not others. Treas. Reg. section 1.702-1(a)(8)(ii) requires that each partner must take into account separately his or her distributive share of any partnership items that, if taken into account, would result in an income tax liability for that partner different from that which would otherwise result. This is why the partnerships are not permitted to deduct interest expense on page 1 of Form 1065 in computing

ordinary net income. In addition, a partnership engaged in the trade or business of securities trading may not treat portfolio interest expense allocated from another partnership as a trade or business expense, since the character of the item is determined at the partnership level.

NOTE: Although the instructions for Investment Interest on Form 4952 provide that for "any portion (which) is attributable to a trade or business in which you did not materially participate and that is not a passive activity, enter that part of the interest expense on the schedule where you report other expenses for that trade or business," there does not appear to be any statutory authority for that position.

Examination Techniques

The starting point for an examination of a Syndicated Investment Partnership is to obtain a copy of the "Offering Memorandum" which is required by the Securities Exchange Commission to be provided to investors. This document should contain a complete description of the management fees, objectives, the principals and other useful information. A discussion of the tax treatments and risks is usually included. A copy of the original Partnership Agreement will be included as an exhibit, but the examiner should request copies of any Amendments.

Where the partnership reports little long-term capital gain, or where it is attributable entirely to IRC section 1256 straddles, trade or business is not likely to be an issue. In determining whether the partnership is engaged in the trade or business of securities trading, the Investment Objectives portion of the Offering is of paramount importance. Objectives other than taking advantage of short-term market movements negate securities trader status.

Where the managing partner is a flow-through entity, request a copy of the return. The managing partner is performing personal services, although the income received may be characterized as interest, dividends, and capital gains. If family members or trusts have an interest in the managing entity, see FAMILY PARTNERSHIPS above to ensure that proper allowance has been made for personal services performed.

Issue Identification

Does the partnership claim long-term capital gains and expenses deducted as business expenses, either on page 1 or as "Other Deductions" on line 11 of Schedule K?

Is there a substantial amount of interest expense? Is it separately stated as Investment Interest Expense on line 14a of Schedule K?

Is profit and loss allocated based on something other than capital; that is, are the profit and loss ratios on the Schedules K-1 different than the capital percentage? This indicates that the managing partner gets a special allocation of profits for services. Is this income allocated only to those performing services?

Documents to Request

1. Offering Memorandum or Private Placement Memorandum
2. Partnership Agreement and any Amendments thereto ("Articles of Organization" in the case of LLCs)
3. Copies of manager's return if the managing partner is a flow-through entity
4. Sample correspondence provided to partners with their Schedules K-1
5. A calculation of partnership tax basis if the partnership is using accrual/mark-to-market for book and cash for tax.

Supporting Law

Higgins v. Commissioner 61 S Ct. 475 (1941) ─ There the Court stated that **"No matter how large the estate or how continuous or extended the work required may be, managerial attention to your own investments does not constitute a trade or business."** In addition, the decision provides the basis for allocating expenses between investment and trade or business.

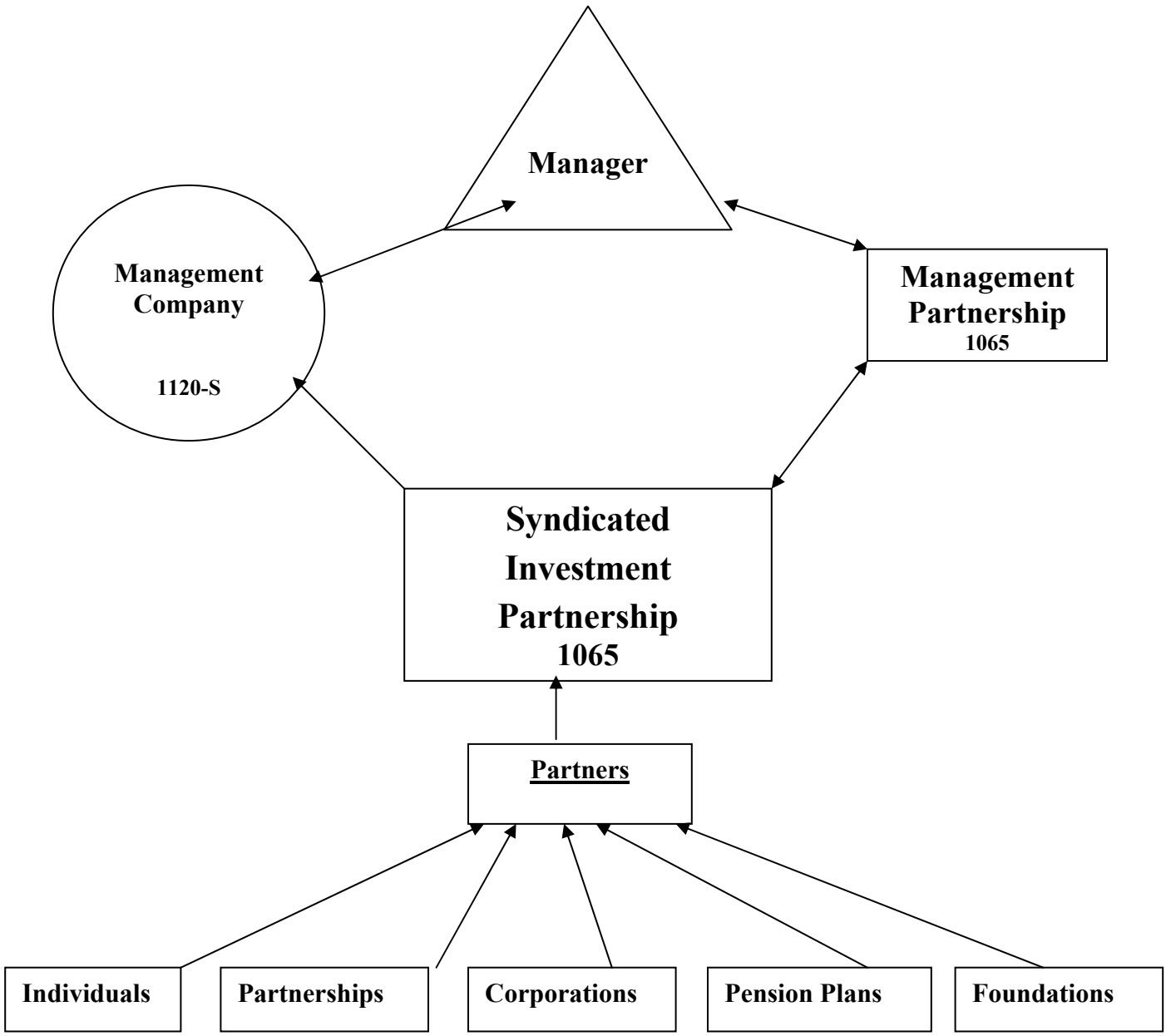
Levin v. United States, 79-1 U.S.T.C. 9331 ─ **"**Although the Supreme Court has yet to find a taxpayer properly characterized as a 'securities trader,' it is clear that such a 'businessman' exists, given the proper facts."

Liang v. Commissioner (23 T.C. 1040) ─ "(with an investor), securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis."

Mayer v. United States, 94-2 U.S.T.C. 50,509 ─ "To claim a trade or business deduction, taxpayer must himself perform the activity characterizing the 'trade or business' citing ***Groetzinger*** (87-1 U.S.T.C. 9191).

Exhibit 12-1

Syndicated Investment Partnerships



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Chapter 13
TEFRA

INTRODUCTION

This chapter is designed to give the reader a basic understanding of TEFRA (Tax Equity & Fiscal Responsibility Act of 1982) and certain of its critical aspects. It is not intended to be a fully comprehensive work. Certain of the topics are covered by way of reference to the governing statutes, regulations, or IRM rather than by way of a narrative text. The *Resources* section lists several published sources which, when viewed together, should present a fully comprehensive and up-to-date picture of TEFRA. In addition, concurrent with the preparation of this Partnership MSSP Guide, the TEFRA Technical Advisor has prepared a TEFRA Computer Based Training Module (CBT) on CD-ROM.

This chapter will address TEFRA only as it applies to TEFRA partnerships and TEFRA related partners. TEFRA, as it applies to S corporations and REMICs, is not covered. Neither are non-TEFRA partnership statute considerations or procedures covered. The differences between TEFRA and non-TEFRA are significant. In regards to non-TEFRA considerations, examiners should consult IRM 4.29 Partnership Control System (PCS) Multi-Functional Handbook, and IRM 4.31, Flow-Through Entity Multi-Functional Handbook.

IRC sections 6221 through 6234 govern audit, administrative, and judicial procedures, as well as certain filing requirements, to be used by entities qualifying as TEFRA partnerships. These procedures are referred to as, "unified proceedings." These Code sections provide that examination, administrative, and judicial actions are conducted at the partnership level.

Final Regulations were recently issued and are effective for taxable years beginning on or after October 4, 2001, (66 FR 50541, Treas. Reg. section 301.6221-1 through 301.6233-1.) For taxable years beginning before October 4, 2001, the Temporary Treasury Regulations continue to govern (Treas. Reg. section 301.6221-1(f)). The Final Treasury Regulations are substantially similar to the previously proposed and temporary regulations.

IDENTIFYING THE TEFRA PARTNERSHIP

It is critical to the examination of a partnership that the examiner recognize whether he or she is dealing with a TEFRA or Non-TEFRA partnership. The reason for this is that the above Code sections only apply to TEFRA partnerships. Failure to

properly identify a TEFRA partnership from the outset will invariably impact the statute of limitations, proper initiation of the examination and other administrative considerations, both at the partnership and partner level.

The identification of a TEFRA entity is essentially governed by IRC section 6231. While this section of the Code addresses conditions under which the partnership return will be exempted from being considered a TEFRA entity, we will look at the return from the aspect of what may qualify it as a TEFRA partnership.

Generally, a partnership with **11 or more partners at any one time during the partnership's tax year is a TEFRA partnership.** Treas. Reg. section 301.6231(a)(1)-1(a)(1) and Temp. Treas. Reg. section 301.6231(a)(1)-1T(a)(1).

CAUTION: A husband and wife, each having their own partnership interest (separate Schedules K-1) are considered one partner, irrespective of their filing status. A jointly held interest (one K-1) also qualifies as one partner for purposes of the count. (Sections 6231(a)(1)(B) & (12) and Reg. 301.6231(a)(1)-1(a)(1) and Temp. Reg. 301.6231(a)(1)-1T(a)(1)).

CAUTION: An individual who has died during the year and his or her estate, each of whom is represented by a separately prepared Schedule K-1, are considered one partner. This determination is consistent with the "at any one time" rule.

A partnership containing less than 11 partners will qualify as a TEFRA partnership if it meets any of the following requisites.

It has as a partner any one of the following:

- Partnership
- Limited liability Company (LLC) which files a Form 1065
- Trust (any type, including Grantor Trusts and grantor type trusts, even if the Schedule K-1 contains the SSN of the grantor)
- Nominee
- Nonresident alien individual
- S corporation
- C corporation – except for partnership taxable years ending after August 5, 1997

CAUTION: The exclusion of a partner, which is a C corporation, as an automatic TEFRA qualifier is a product of TRA '97 (the Taxpayer Relief Act of 1997). The problem presented by this change is whether or not other types of Form 1120 such as Form 1120F should be included. The current position is that all types of Form 1120 (except Form 1120S) are to be treated the same under TRA '97. Further, all corporate entities (other than S corporations) are treated as C corporations for the purpose of the small partnership exception regardless of

whether they are taxable under subchapter C. Consult your local TEFRA coordinator or the Foreign Joint Venture Specialist.

CAUTION: If schedule K-1 identifies the **entity type** of the partner to be a **corporation**, without specifying that the partner is an **S corp**., and this determination is critical to qualifying the return as either TEFRA or non-TEFRA, the examining agent should secure an IDRS print to settle the issue. The year researched for the partner must be the same year as the partnership being examined. This is also recommended where the partner is identified as a LLC. Confirm whether the partner has filed a Form 1120 or Form 1065.

Prior to enactment of TRA '97, a partnership of less than 11 partners qualified as a TEFRA entity if it failed the **"same share test,"** (Temp. Treas. Reg. section 301.6231(a)(1)T-1(a)(3)). The same share test was repealed by TRA '97.

A partnership which does not otherwise qualify, can elect to be treated as a TEFRA partnership (IRC section 6231(a)(1)(B) and Treas. Reg. section 301.6231(a)(1)-1(b) and Temp. Treas. Reg. section 301.6231(a)(1)-1T(b)).

CAUTION: Checking the "yes" box on page 2 of Form 1065 which asks the question, "Is this partnership subject to the consolidated audit procedures of sections 6221 through 6234?" does not constitute an election. Nor does the designation of a TMP, in and of itself, constitute a proper election.

CAUTION: The election is only required to be included with the first return for which it is effective, and once made, is effective until revoked with the consent of the Commissioner. In instances where the partnership would not appear to qualify as a TEFRA entity, but designates a TMP on the tax return or responds positively to the consolidated audit procedures question, inquiry should be made as to whether there is an election in effect. The examiner should secure the partnership's file copy of the election and determine if the election is valid under section 301.6231(b)(2) of the Regulations. If not valid, the partnership is not a TEFRA entity. If the election is determined to be valid, attach a copy to the examined partnership tax return.

For tax years ending after August 5, 1997, partnership information can be relied on for determining if the TEFRA procedures apply. Internal Revenue Service personnel must be **reasonably** assured that the information on the return is correct. To meet the **reasonable** determination standard, additional information should be secured, if necessary. The **reasonable factor** is likely to be a source of litigation in the future. The examiner's TEFRA/non-TEFRA determination should be reviewed with the local TEFRA coordinator and clearly documented in the workpapers.

CAUTION: Based on the changing number or type of partners within the partnership, as well as changes in the law, a partnership may qualify as a TEFRA partnership in one year, while being treated as a non-TEFRA partnership in another. All qualifying tests should be applied to each tax year of the partnership.

Electing large partnerships (Form 1065B) and their partners are subject to a special form of unified proceeding. They are not subject to the regular TEFRA Code sections 6221-6234 (section 6240(b)(1)). TRA'97 established audit procedures for electing large partnerships with **new Code sections 6240-6255** effective for partnership taxable years beginning after December 31, 1997. Examiners should review the provisions of IRC sections 771-777 and 6240-6255 before commencing an electing large partnership examination.

CAUTION: If an **electing large partnership is a partner in a TEFRA partnership** which is not an electing large partnership, the **TEFRA Code sections will apply to items of the electing large partnership which are partnership items with respect to the TEFRA partnership** (IRC section 6240(b)(2)).

TAX MATTERS PARTNER (TMP) -- DESIGNATION

The proper designation of a **qualified** tax matters partner is critical. An improper designation can invalidate a statute extension or the binding effect of agreements on non-notice partners. In short, an invalid TMP is the equivalent of no TMP.

A TMP can be designated by the partnership or selected by the IRS.

The process by which a TMP is designated is covered in section 301.6231(a)(7)-1 of the Treasury Regulations.

The process by which a TMP is designated for an LLC is covered by section 301.6231(a)(7)-2 of the Treasury Regulations.

When the partnership fails to designate a TMP, or the designation has been terminated and the partnership has not made a subsequent designation, IRC section 6231(a)(7)(B) and Treas. Reg. section 301.6231(a)(7)-1(m) provide that the general partner having the largest profits interest be determined to be the TMP. Paragraph (m)(2) of this section contains instructions for calculating the profits interest of the general partners and provides that when more than one such partner has an identical interest, the TMP will be the partner whose name appears first, alphabetically. (Also, refer to IRM 121.5.1.12.8.11.)

When it is impracticable to apply the largest-profits-interest rule, the Commissioner may select as tax matters partner any person who was a general partner at any time during the taxable year and owned a profits interest. If a general partner cannot be selected, the Commissioner may select any partner who was a partner in the partnership at the close of the taxable year under examination. The Commissioner's selection of the TMP is covered by Treas. Reg. sections 301.6231(a)(7)-1(n) through

(r) and Temp. Treas. Reg. section 301.6231(a)(7)-1T(p)(2) & (r)(1). The criteria for selection is contained in Treas. Reg. section 301.6231(a)(7)-1(q).. The Commissioner is required to notify both the partner selected and the partnership of the selection (Temp. Reg. section 301.6231(a)(7)-1T(r)(1)). However, 30 days prior to making the selection, the Commissioner must notify the partnership by mail of the intent to select a TMP (Treas. Reg. section 301.6231(a)(7)-1(r)(2)). This notification is designed to give the partnership a window of opportunity to designate a TMP. (Also, refer to IRM 121.5.1.12.8.12.)

The qualifications required to be designated by the partnership as the TMP are set forth in Treas. Reg. section 301.6231(a)(7)-1(b).

Events which serve to terminate the TMP designation are listed in Treas. Reg. sections 301.6231(a)(7)-1(l) and 301.6231(c)-4 through 301.6231(c)-8 and Temp. Treas. Reg. section 301.6231(c)-4T through 8T.

CAUTION: When a terminating event occurs, the partner's status as TMP terminates. All acts performed by the TMP prior to the occurrence of the terminating event would be considered valid. Any subsequent actions would not. The designation of a new TMP will be required, before securing statute extensions or settlements from a new TMP.

CAUTION: The TMP designation entered on Form 1065 should not be accepted, automatically. Verify that the TMP designated in this manner is qualified and that no terminating event has occurred from the time the partnership return was filed to the present.

CAUTION: In a multiple year exam, do not assume that the TMP for one year is the TMP for another. Verify the TMP designation for each year.

TAX MATTERS PARTNER – AUTHORITY AND RESPONSIBILITIES

The IRS deals primarily with the TMP for all administrative and judicial proceedings.

The TMP can sign an assortment of documents, such as Form 872-P, however, see Temp. Treas. Reg. section 301.6229(b)-1T.

The authority and responsibilities of the TMP are set forth in Treas. Reg. sections 301.6223(g)-1 and 301.6230(e)-1.

CAUTION: Generally, the authority and responsibilities of the TMP should not be delegated to the Power of Attorney. The execution of a “stock” Form 2848, Power of Attorney and Declaration of Representative, will typically limit the POA’s role in a TEFRA exam to providing and receiving information. However,

Treas. Reg. section 301.6229(b)-1 allows the partnership to authorize **any person** to extend the period described in IRC section 6229(a) – Period of Limitations for Making Assessment. The examining agent must verify that the partnership has complied with all of the requirements of Treas. Reg. section 301.6229(b)-1.

PARTNERSHIP ITEMS/NON-PARTNERSHIP ITEMS/AFFECTED ITEMS

- Partnership items: A partnership item is an item that is more appropriately determined at the partnership level than at the partner level (IRC section 6231(a)(3)).

- Affected items: An affected item is any item that is affected by a partnership item (IRC section 6231(a)(5)).

- Non-partnership items: A non-partnership item is an item that is not a partnership item or is treated as other than a partnership item (IRC section 6231(a)(4)).

Partnership Items

Treas. Reg. section 301.6231(a)(3)-1 provides a listing of partnership items. Partnership items are comprised of:

- Items which appear on the partnership tax return

- Other issues which are more appropriately determined through an examination of the partnership's books and records.

Items appearing on the partnership return are more or less obvious and can consist of items other than distributive share items of the partnership such as liabilities, including determinations with respect to the amount of the liabilities, whether the liabilities are recourse or non-recourse and changes from the preceding taxable year. Partnership items also include items which are utilized by the partners for computational purposes only. Some of these are:

- Tax preference items used in the computation of alternative minimum tax.
- Items entering into the partner's calculation of the current deduction for investment interest.
- Net earnings from self- employment used in the calculation of the partner's liability for self-employment tax.

Other issues may consist of the identification of the character of a distribution. Is it a distribution that is the equivalent of a withdrawal or is it a liquidating distribution or debt-financed distribution? If property has been distributed, does it consist of "hot" and/or "cold" assets? Without these characterizations being

determined at the partnership level, the partner would have no basis for characterizing the tax consequences of the distribution.

Partnership items can only be adjusted through a TEFRA proceeding. The TEFRA assessment statute, IRC section 6229 only applies to partnership items and items directly affected by partnership items **(affected items)** and items which were once partnership items (converted items)**.** The statute of limitations under IRC section 6501 need not be considered, although, at times, there can be interplay between the two (see *Statute of Limitations* on the following pages).

Affected Items

An affected item is any item that is affected by a partnership item. Examples are given in Treas. Reg. section 301.6231(a)(5)-1. Since an affected item is defined as any item which is affected by a partnership item, the path to identifying these items lies in an understanding of how partnership items can affect a partner's tax return/liability.

A **computational adjustment** is directly assessed where the effect of the partnership item on the partner's tax liability can be computed mathematically without further determinations at the partner level. If the adjustment to a partnership results in an increase to the partner's adjusted gross income, any items on the partner's tax return, the threshold for deductibility of which is governed by the reported amount of AGI, will be affected. Directly assessed c**omputational adjustments** are also appropriate when items such as tax preference items, investment income, deductions, and interest are used for the calculation of alternative minimum tax and the currently allowable deductions for investment interest expense, respectively. If an adjustment requires additional partner level determinations before an assessment can be made, that portion of the assessment will be made through an affected item notice of deficiency.

Typically, penalties are **affected items** which require partner level determination. This type of affected item is subject to deficiency procedures (IRC section 6230(a)(2)).

The Revenue Reconciliation Act of 1989 (the 1989 Act) consolidated penalties for negligence (IRC section 6653), overvaluation (IRC section 6659) and substantial understatement (IRC section 6661) into IRC section 6662 referred to as the "accuracy related" penalty. Under TRA '97, for partnership years ending after August 5, 1997, the applicability of penalties relating to adjustments to partnership items are determined at the partnership level. The penalty is assessed in the same manner as partnership items. Treas. Reg. section 301.6221-1(c) & (d). Partner level defenses can only be raised through refund claims.

Innocent spouse relief is an affected item. Currently, IRM 104.5, Relief from Joint & Several Liability Handbook, has a section "reserved" for TEFRA. As of the preparation of this MSSP Guide the Service will consider innocent spouse requests for relief from TEFRA proceedings only **after** there is a final determination concerning the treatment of partnership items (for example, a

settlement is entered into, or the decision of the court becomes final). An as yet unnumbered letter has been drafted, which should serve to apprise taxpayers with a request for innocent spouse relief on file of the Service's current policy.

The following are some items that are affected items requiring partnership level determinations under the TEFRA provisions, followed by partner level affected item notices of deficiency along with some (but not all) of the issues to be given consideration at each level:

- **Outside basis**

  Partnership level:
  - Cash contributions
  - Distributive items of income, losses and deductions
  - Distributions
  - Partner's basis in contributed property (that is, IRC sections 704(c) and 722)

  Partner level:
  - Price paid if interest purchased from another partner and no section 754 election

- **At-risk**

  Partnership level:
  - Partner's share of liabilities
  - Nature of liabilities (recourse and non-recourse)

  Partner level:
  - Partner's obligation in respect of borrowed funds used in acquiring the partnership interest
  - Outside basis determined at partner level

- **Passive losses:**

  Partnership level:
  - Activity engaged in by the partnership (whether it is a rental activity)
  - Portfolio income

  Partner level:
  - Material participation
  - Real estate professional

- **Cancellation of indebtedness (COD):**

  Partnership level:
  - Income from COD

Partner level:

Exclusion under IRC section 108 --

For example, a determination of the extent to which the partner is insolvent, bankrupt or elects to reduce basis can only be made at the partner level.

An affected item may require a determination and adjudication at the partnership level for its partnership item components, and a determination and adjudication at the partner level for its partner level components. In ***Roberts v. Commissioner***, 94 T.C. 853 (1990), the issue was at-risk. The Service had failed to examine the partnerships involved and the statute of limitations under IRC section 6229(a) had expired. An examination at the partner level revealed that the partner had entered into a series of side agreements, which limited the exposure to debt/loss. The partner took the position that the determination of amount at-risk under IRC section 465 was exclusively a partnership item (Treas. Reg. section 301.6231(a)(3)-1(a)(1)(vi)(C)). The partner further stated that, as a consequence, the issue should have been raised in a partnership proceeding. The Service conceded the partnership level components since the period for correcting a partnership proceeding had expired. Never-the-less, it argued that it could still adjust the partner level components through a notice of deficiency. The Service argued that "the existence of a partner-level, third party side agreement and its effect on a partner's amount at-risk may be adjudicated as a partner level determination in an affected item deficiency proceeding." (See Temp. Treas. Reg. section 301.6231(a)(5)-1T(c)). The Court held that "the partner's amount at-risk under IRC section 465 was not an item required to be determined by the partnership and, therefore, is not a "partnership item" within the meaning of IRC section 6231(a)(3)." The Court also held that the government's "notice of deficiency making the at-risk disallowance at the partner level was appropriate."

Non-partnership Items

Partnership items become non-partnership items for any partner as a result of the occurrence of a conversion event (IRC section 6231(b) & (c)). Non-partnership items resulting from a conversion event (except settlement agreements) are assessed under normal deficiency procedures applied at the partner level. The partner is no longer part of the TEFRA proceeding. The statute of limitations for converted items is under IRC section 6229(f).

STATUTE OF LIMITATIONS

Briefly, the statute of limitations for the key case TEFRA partnership becomes the statute of limitations for all of its partners. This concept extends to the investors in tier flow-through entities. However, the statute of limitations established at the key case level does not extend to issues raised on the tier's own tax return. For this, separate statute consideration must be given to the tier return as a **key case**. If the tier partnership is not itself a TEFRA partnership, separate statute extension will be required from the partners under IRC section 6501. IRC section 6229

contains the rules for the TEFRA assessment statute as well as deviations which apply to a variety of circumstances. In the case of a false or fraudulent return, IRC section 6229(c)(1)(B) provides for an unlimited statute of limitations for any partner who signed, or participated directly or indirectly in the preparation of the return and a 6-year statute for all other partners. In the case of a substantial omission of income, IRC section 6229(c)(2), and in the case of a false return for **non-culpable** partners, IRC section 6229(c)(1)(B), provide for a **6-year statute** in place of the normal 3-year statute for all partners. IRC sections 6229(c)(1)(A) & 6229(c)(3) & (4) provide for **no limitation** on the TEFRA assessment statute for certain partners **responsible** for the filing of a false return and all partners when the partnership fails to file a return. The examination of a TEFRA partnership should include total familiarity with IRC section 6229.

IRC sections 6229 and 6501 are not always mutually exclusive. The application of IRC section 6229(b)(3) is one such example. Here, a statute extension secured under IRC section 6501(c)(4), if properly worded, will keep open that particular partner's statute of limitations for partnership items.

NOTE: Chief Counsel has advised that, in certain circumstances, their office would be willing to defend the position that IRC section 6229 merely sets forth a minimum period during which the partner's period for assessment under IRC section 6501 shall not expire for partnership items. Chief Counsel suggests that if the IRC section 6229(a) statute has expired with respect to partnership items, but the IRC section 6501 statute remains open for one or more partners, consult with local Counsel for a determination as to whether the case should be conceded or not. Neither the agent nor his manager can make the determination to rely on the IRC section 6501 statute. **Only Chief Counsel can make this determination**. The same approach is suggested for an expiration of the IRC section 6229(f) statute for converted items. See ***TEFRA UPDATE 1998, Tax Equity and Fiscal Responsibility Act***, Document 10808 (4-98).

ADMINISTRATIVE ADJUSTMENT REQUEST

An Administrative Adjustment Request (AAR) is an amended return for partnership items.

IRC section 6227 contains the authority and procedures for AARs. IRC section 6228 provides for judicial review where the AAR is not allowed in full.

The period within which an AAR must be filed is governed by IRC section 6227(a), (b) & (e).

Aside from calendar parameters, the AAR cannot be filed after the mailing to the TMP of an FPAA with respect to the year in question (IRC section 6227(a)(2)).

A superseding return is an amended return received on or before the due date of the original return. **An AAR cannot be treated as a superseding return.**

TMP Filed AAR on Behalf of the Entire Partnership

An AAR can be filed by the TMP for the entire partnership. The AAR must be filed by the TMP on behalf of the partnership on the form prescribed by the Service for that purpose in accordance with the instructions accompanying that form (Treas. Reg. section 301.6227(b)-1(a)). The form so prescribed is Form 8082. This section of the Regulations provides additional filing instructions and requires that the AAR be accompanied by revised schedules showing the effects of the proposed changes on each partner and an explanation of the changes (Treas. Reg. section 301.6227(b)-(1)(a)(3)). An AAR package must also include the amended return and revised schedules K-1 for the affected partners.

The TMP may request that the AAR receive substituted return treatment (IRC section 6227(c)(1)(A)). When the AAR is filed in this manner, the Service may treat the changes shown on the AAR as corrections of mathematical or clerical errors appearing on the partnership return (IRC section 6227(c)(1)(B)). The IRS may credit or refund any overpayment of tax to the partner(s) based on the AAR, or assess any resulting tax without a deficiency or partnership level proceeding, if no partner objects.

When an AAR is filed requesting substituted return treatment and a partnership proceeding under IRC section 6223 is not initiated, partner tax assessments can only be made after the affected partners are mailed a notice of the correction of the error and no partners, within the allotted 60-day period, request that the correction not be made (IRC section 6230(b)). The receipt of an objection from one or more of the partners may be resolved through initiation of a TEFRA proceeding.

When an AAR is filed with tax assessment consequences for at least one partner, failure to request substituted return treatment will mean that the Service cannot assess tax without a partnership level proceeding.

If the AAR does not have tax assessment consequences for any of the partners, requesting substituted return treatment will not be necessary. If the AAR is accepted as filed, refunds can be made to partners without a partnership level proceeding.

When the AAR is not treated as a substituted return, the Service has three options under IRC section 6227(c)(2):

1. Accept the AAR as filed and allow any refunds or credits due to the affected partners arising from the adjustments shown on the AAR. See IRC section 6227(c)(2)(B) for partners with converted items.

2. Conduct a partnership proceeding wherein normal TEFRA procedures will apply.

3. Take no action on the AAR.

If an AAR filed by a TMP is not allowed in full, or alternately, the Service takes no action on the AAR, IRC section 6228(a) provides for the filing of a petition by the TMP for an adjustment with respect to the partnership items to which such part of the request (AAR) relates.

IRC section 6228(a)(2) provides a time frame for filing the petition and can be extended for the partnership by execution of Form 9248 (Form 9247 for a partner level AAR). Under IRC section 6228(a)(2)(B), a petition cannot be filed once a Notice of Beginning of Administrative Proceeding (NBAP) has been mailed to the partnership with respect to the year covered by the AAR. The petition would then be filed under the provisions of IRC section 6226 once an FPAA is issued.

The partnership's failure to keep the period for filing a petition open under IRC section 6228 will jeopardize the partners' right to receive refunds or credits (IRC section 6230(d)).

The right to petition under IRC section 6228(a) is also available for AARs requesting substituted return treatment wherein the Service has either not granted the request for such treatment or has failed to take timely action on the request (Treas. Reg. section 301.6227(b)-1(b)).

CAUTION: A partnership level AAR which the Service concludes should be accepted as filed must have a PCS package submitted to link the affected partners. If there will be no partnership proceeding, use Form 8341 instead of Form 8340 as NBAPs should not be mailed. Failure to link the affected partners will result in inactivity at the partner level. No assessments, refunds or credits will be made. This will give the appearance of "no action taken" on the AAR.

An in-house report should be prepared. The RAR takes the partnership from the original return presentation to the amended return amounts, as expressed in the AAR. The RAR will become the basis for the closing package submitted to the service center. Your service center may allow you to attach the amended Schedules K-1 to the RAR, in lieu of completing Form 886-Z.

Note, however, that IRM 121.5.2.3.1(5)(a) appears to require only that a Form 886-Z(C) be prepared.

CAUTION: The processing of an AAR, in accordance with the IRM, cannot be avoided with the expectation that any refunds or credits due the partners will be allowed upon receipt of the partner's amended return. Prior to TEFRA, each partner was required to file an amended return to reflect changes made by the partnership in its amended return. IRC section 6227 provides for a direct change to the tax liability of the partners by the filing of an AAR at the partnership level.

The partners are not required, nor encouraged, to file their own amended returns. (See IRC section 6230(d)(5)). Partnership level AARs with tax assessment consequences for the partners are of special concern. Do not rely on the partners filing amended tax increase returns. IRC section 6227 allows for assessments against the partners either through a partnership proceeding or substituted return treatment. Again, the partners are not required to file an amended return under the unified partnership rules.

CAUTION: Allowance of an AAR that merely reallocates partnership items between the partners should not be treated as a "no-change," especially in a partnership proceeding. Partnership items include the partnership's aggregate and each partner's share of items of income, gain, loss, deductions, or credits of the partnership, etc. (Treas. Reg. section 301.6231(a)(3)-1(a)).

AAR Filed by a Partner

A partner can also file an AAR. If the partner's AAR is predicated on the partnership having filed an AAR of its own, the partner's AAR should be suspensed and the issue addressed at the partnership level. If the partner AAR is not predicated on the partnership having filed an AAR, Form 8082 should serve as a Notice of Inconsistent Treatment. The issue(s) raised in a Notice of Inconsistent Treatment or an AAR of this type can be addressed through a partnership level proceeding. Optionally, the Service may mail to the partner a notice that **all partnership items** of the partner for the year to which such AAR relates shall be treated as non-partnership items (IRC section 6231(b)(1)(A)) only if no TEFRA proceeding is initiated. Subsequent to the notice of conversion being mailed, the AAR is treated as a claim for credit or refund of an overpayment attributable to non-partnership items (IRC section 6228(b)(1)(A)). The request to have partnership items converted to non-partnership items should be routed to local Counsel through the local TEFRA coordinator. The authority for granting the conversion has not been delegated beyond the Commissioner.

Refer to IRM 121.5.2.3.2 for options regarding the processing of partner level AARs and Form 8150 procedures for situations in which the partner's AAR and an AAR filed on behalf of the TEFRA partnership are filed at different service centers.

NOTICE OF INCONSISTENT TREATMENT

IRC section 6222(a) requires that the partner's treatment of partnership items be consistent with the treatment of that item by the partnership in all respects including the amount, timing and characterization of the item (Treas. Reg. section 301.6222(a)-1(a)). If a partner does file a return which is not consistent with the partnership, the partner must inform the Service of the inconsistency (IRC section 6222(b)). The notice is given on Form 8082. The form must identify **all** partnership items that are treated inconsistently. If any item is omitted from the form it will be subject to the treatment for non-notification (Treas. Reg. section 301.6222(b)-2(b)). Form 8082 must be attached to the partner's tax return. If the inconsistency is the subject of the partner's amended return, Form 8082 must be attached to that.

When the partner has given the Service proper notification, an assessment of tax can only be made as a result of a partnership proceeding, or by notifying the partner that **all partnership items** arising from that partnership will be treated as non-partnership items (Treas. Reg. section 301.6222(b)-2(a)) followed by the issuance of a notice of deficiency. The IRS has the option to convert partnership items to non-partnership items (IRC section 6231(b)(2)(A)). See the discussion of the Service's notice to convert partnership items to non-partnership items under *"AARs Filed by a Partner."*

If the partner has treated a partnership item inconsistently with the partnership's treatment and fails to notify the Service of the inconsistent treatment, the tax attributable to the inconsistent treatment can be directly assessed by computational adjustment. The partner may also be subject to a negligence penalty (IRC section 6222(d)). An indirect partner can be inconsistent with the pass-through partner as long as he is consistent with the source/key case partnership (Treas. Reg. section 301.6222(a)-2)).

Form 8150 procedures, similar to that of partner filed AARs, may be necessary for the Notice of Inconsistent Treatment.

CAUTION: IRC section 6222(b)(1)(A)(ii) allows the partner to file a Notice of Inconsistent Treatment when the partnership has not filed a return (the partner has not received a Schedule K-1). In most instances the partner will report zero distributive items pending receipt of the Schedule K-1.

KEY TEFRA DATES FOR EXAMINER

- The examination cannot be started with less than 12 months remaining on the statute of limitations, unless approval of the LMSB, Director of Field Operations, or the SB/SE or W & I equivalent is secured (IRM 121.5.12.10.1).

- If the case is closed no-change within 45 calendar days of the issuance of an NBAP to the TMP (the first NBAP), certain procedural requirements can be avoided (IRM 1212.5.12.10.4(7)).

- An FPAA should not be mailed less than 120 days from the date the last NBAP is mailed to a notice partner (IRC section 6223(d)(1)). See the *Hillcrest Letter,* Exhibit 121.5.1-3 of IRM 121.5.

- An FPAA must be mailed to each notice partner no later than 60 days from the date the FPAA is mailed to the TMP (IRC section 6223(d)(2)).

Supporting Law

IRC sections 6221 through 6234

IRC section 6501

Supporting regulations

TRA'97

RRA'98

Historic litigation cited in "resources" below

Current litigation (LEXIS)

Resources

Mather, BNA, Tax Management Portfolio No. 467, Audit Procedures for Pass-Through Entities

Hesch, BNA, Tax Management Portfolio No. 710, Partnerships: Overview, Conceptual Aspects, and Formation

Office of Chief Counsel, TEFRA UPDATE 1998, Tax Equity and Fiscal Responsibility Act, Document 10808 (4-98)

Kelly, Dennis M., as updated by Ransick, Mark, An Overview of TEFRA Partnership Proceedings, Including the Taxpayer Relief Act of 1997, and Restructuring and Reform Act of 1998 (October 1998)

IRM 4.29, Partnership Control System (PCS) Multi-Functional Handbook

IRM 4.31, Flow-Through Entity Multi-Function Handbook

Instructions to Form 8082.

For further information, contact the TEFRA Technical Advisor in LMSB.

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GLOSSARY

AAR (Administrative Adjustment Request)

A request by the Tax Matters Partner on behalf of all partners or a request by a partner in his own behalf to have the Service adjust partnership items, usually for the purpose of seeking a refund.

Abandonment

The surrender of all legal rights to a partnership interest by some overt action on the part of a partner with the expectation of receiving nothing in return.

Affected item

Any item affected by a partnership item. IRC section 6231(a)(5).

Aggregation of activities

The grouping together of certain activities to which the at-risk rules apply.

Alternate economic effect test

An alternative mechanical test for determining whether the allocation of a tax item of the partnership has economic effect that is used when a partner does not have an unconditional obligation to restore a negative capital account balance when the partnership is liquidated and that relies on the existence of a qualified income offset (QIO) provision.

Anti-abuse rules

Rules, such as Treas. Reg. section 1.701-2 or more specific rules in other regulations, that allow the Service to implement the intent of all or part of Subchapter K.

Assumption

The act of taking over the obligation of another, such as the obligation to repay a loan.

At risk

The amount of money or property for which a partner bears the risk of loss and the amount of borrowing for which the partner is personally liable for repayment.

At risk recapture

Any amount of previously allowed losses that is treated as income from the activity when, and to the extent that, the taxpayer's amount at risk in an activity is reduced below zero.

Automatic Stay

An order issued by bankruptcy court which prevents any creditor from collecting a liability against a person for which a bankruptcy petition has been filed.

Avoiding Powers

The trustee may avoid a transfer of an interest of the debtor in property.

Bankrupt

A taxpayer who has received a discharge under Title 11 of the United States Code. A taxpayer who has been adjudicated as bankrupt by a United States Bankruptcy Court.

Bar Date

The date by which all creditor's claims must be filed with the bankruptcy court.

Bargain sale

The amount of debt relief to a partner who contributes his partnership interest to a charitable organization.

Basis/adjusted basis

The cost of an asset, later adjusted by specific events (for example., allocation of income or loss in the case of the basis of a partnership interest).

Book capital accounts

Accounts included in a partnership's balance sheet that reflects the partners' economic interests in the partnership.

Built-in gain

The excess of the fair market value of property contributed to a partnership over its adjusted basis.

Built-in-Gain or Loss

The difference between a property's fair market value and its basis at the time of contribution.

Built-in loss

The excess of the adjusted basis of property contributed to a partnership over its fair market value.

Capital account

An account included in a partnership's balance sheet that reflects the partners' economic interest in the partnership.

Character of gain or loss

Capital or ordinary, determined by looking at the source of the gain or loss.

Charitable organization

IRC section 170(c) defines a domestic charitable organization as U.S.-based, organized and operated exclusively for a qualified charitable purpose, with no earnings that inure to the benefit of any private shareholder or individual.

COD - Cancellation of Indebtedness income.

Cold asset/capital asset

An asset that would produce capital gain or loss.

Collapsible partnership

A partnership to which IRC section 751 applies.

Compliance period

With respect to any building, the period of 15 taxable years beginning with the 1st taxable year of its credit period.

Computational adjustment

The change in the tax liability of a partner reflecting the proper treatment of partnership items under the TEFRA provisions. IRC section 6231(a)(6). This is the amount that is assessed following a TEFRA proceeding.

Contingency

An event that may occur.

Contribution

A transfer of cash or property to a partnership in exchange for a partnership interest.

Contributing partner

Any partner who contributes a particular asset with a built-in gain or a built-in loss to the partnership.

Constructive ownership

A taxpayer's ownership through attribution of a capital interest or a profits interest in a partnership resulting from the taxpayer's relationship with other persons that own interests directly or indirectly in the partnership.

Converted item

A partnership item which has converted to a non-partnership item pursuant to IRC section 6231(b) or (c).

Credit period

The period of 10 taxable years beginning with either the taxable year in which the building is placed in service, or, at the election of the taxpayer, the succeeding taxable year, but only if the building is a qualified low-income building as of the close of the 1st year of such period.

Current distribution/Non-liquidating distribution

A distribution to a partner not in liquidation of the partner's entire interest. Includes a distribution in partial liquidation of a partner's interest as well as a distribution of the partner's distributive share of current partnership income.

Current distributions

Distributions that do not retire completely the partnership interest of the distributee partner.

Dealer

Someone who buys and sells securities for others.

Deemed cash contribution

The method IRC section 752 uses to increase a partner's outside basis for that partner's share of the partnership's liabilities.

Deemed contribution

The tax treatment associated with an increase in a partner's share of partnership liabilities.

Deemed distribution

The tax treatment associated with a reduction in a partner's share of partnership liabilities.

Deemed Exchange

The result of an increase in a distributee partner's interest in the value of one class of property while his interest in the value of the other class of property is decreased.

Depreciation recapture

Gain, upon the disposition of depreciable property, that is attributable to depreciation deductions and recharacterized as ordinary income. A type of IRC section 751(a) property.

Discharge

Relief from certain liabilities.

Disguised sale

A transaction that is in form a contribution to a partnership and a distribution, but is in substance a sale or exchange.

Disguised sales

Transactions that use contributions to partnerships and related distributions to disguise what is, in substance, a sale or exchange of property.

Disproportionate Distribution

A distribution which changes the value of a partner's interest in the partnership's hot and cold assets.

Disproportionate Distribution

A distribution that changes the value of the distributee partner's interest in hot or cold assets.

Distribution

A transfer of cash or property by a partnership to a partner.

Distribution in complete liquidation

The termination of a partner's entire interest in a partnership by means of a distribution or a series of distributions.

Donee

The person receiving the gratuitous transfer; the gift recipient.

Donor

The person who makes a gratuitous transfer; the person making the gift.

Economic equivalence test

Even if an allocation fails the primary and alternate economic effect test, the allocation will be respected under the economic effect equivalence test if a liquidation of the partnership occurring at the end of the year in which the allocation takes place would produce the same economic results to the partners as if the primary economic effect test had been met.

Economic substance

Judicial doctrine used to determine whether a transaction or entity serves an economic purpose other than tax savings when determining the proper tax treatment of a transaction.

Encumbered property

Property that is subject to a liability.

Entity theory of partnership taxation

Theory which supports the determination of the tax consequences of partnership operations at the partnership level rather than at the partner level.

Excess distribution

The amount by which the fair market value of the distributed property (other than money) exceeds the distributee partner's adjusted tax basis in his partnership interest.

Exempt Assets

Assets which do not become a part of the bankruptcy estate and which the debtor is permitted to keep while still receiving a discharge in bankruptcy. The kind and amount of exempt assets vary from state to state, but do not included secured assets.

Extended Use Agreement

An agreement recorded under state law between the taxpayer and the appropriate housing credit agency under IRC section 42(h)(6) that requires, among other things, that a certain percentage of the units in the qualified low-income building will continue to be rented to low-income tenants for at least fifteen years beyond the end of the compliance period.

Fair market value

The value of an asset or property as determined by a willing seller and a willing buyer on the open market.

Family member

IRC section 704(e) defines the "family" of an individual as including only his spouse, ancestors and lineal descendants, and any trusts for the primary benefit of such persons. See chapter 11 of this Guide.

Family partnership

See chapter 11 of this Guide.

FPAA (Notice of Final Partnership Administrative Adjustment)

The notice that constitutes the Service's final determination of adjustments to partnership items and initiates the 150-day period for filing a petition in court challenging the Service's final determinations.

"Fruit of the Tree"

Income is attributable to the taxpayer who earned it regardless of his attempt to escape it by anticipatory arrangements and contracts however skillfully devised to prevent the income when paid from vesting even for a second in the taxpayer who earned it.

Gift tax

A tax imposed on a gratuitous transfer. If the tax is paid by the donee there will be income to the donor.

Goodwill

The value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor." See Treas. Reg. section 1.197-2(b)(1).

Gratuitous transfer

A transfer for no consideration; a gift.

Guaranteed loan

A loan the payment of which is guaranteed by a partner.

Guaranteed payments

Payments made to a partner which are not determined with regard to the income of the partnership. See IRC section 707(c).

Holding period

The time that an asset is held, used for determining whether a gain or loss is long-term or short-term.

Hot asset/IRC section. 751 asset

An asset that would produce ordinary gain or loss (unrealized receivables and inventory items). Depreciation recapture is treated as an unrealized receivable.

Income in respect of a decedent (IRD)

Income rights that are not properly included on the decedent's final income tax return.

Indemnification agreement

An agreement whereby a partner agrees to reimburse another partner or the partnership for payments the other party makes, such as the repayment of a loan.

Innocent spouse relief

Relief granted under IRC sections 6015 or 6230(c)(5).

Inside basis

The tax basis that the partnership has in its assets.

Insolvent

A taxpayer whose liabilities exceed the fair market value of his assets.

IRC section 754 election

An election that allows a partnership to adjust its basis under IRC sections 743 (upon transfers of partnership interests) and IRC section 734 (upon distributions to a partner).

IRC section 754 revocation

The revocation of an election under IRC section 754.

Intent of Subchapter K

The intent of Subchapter K is to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit within the intent of Subchapter K are the following: the partnership must be bona fide, each partnership transaction or series of transactions must be entered into for a substantial business purpose, the form of each transaction must be respected under substance over form principles, and the tax consequences must accurately reflect the partners' economic arrangement and clearly reflect the partners' income.

Like-kind exchange

A transaction under IRC section 1031 in which a taxpayer transfers an asset in exchange for another asset of like kind. Exchanges of partnerships interests do not qualify for like kind exchange treatment.

Liquidating distributions

The termination of a partner's entire interest in the partnership by means of a distribution, or a series of distributions.

Loss carryforwards

Suspended losses that are carried forward to a subsequent year and allowed in the first year in which the loss limitations do not limit the allowance of the loss.

Loss limitations

Limits on the allowance of a partner's share of partnership loss based on the partner's outside basis in the partnership, the partner's amount at risk, and the partner's passive participation in the partnership activity.

Low income housing credit

The credit given under section 42 of the Internal Revenue Code to owners of certain low-income housing projects. The amount of the credit is equal to the applicable percentage of the qualified basis of each qualified low-income building.

Mark-to-Market

A method applied to any regulated futures contract, foreign currency contract, nonequity option, dealer equity option, and dealer securities futures contract held by the taxpayer at the close of the taxable year which treats such property as sold for its fair market value on the last business day of such taxable year and any gain or loss is taken into account for the taxable year.

Minimum gain chargeback

A provision that must be included in the partnership agreement in order for the partnership's allocations of non-recourse deductions to be respected, requiring that a partner who receives the tax advantage of a deduction must later be allocated offsetting income in an equal amount.

Mixing bowl transactions

Transactions in which partners arrange to pool their assets in a partnership, and then make related allocations or distributions in order to shift the benefits and burdens of ownership. IRC sections 704(c) and 737 have curtailed these transactions.

NBAP (Notice of Beginning of Administrative Proceeding)

The notice sent to the Tax Matters Partner (with copies to all notice partners) which signals the beginning of a partnership audit.

Net Precontribution Gain

For property contributed to a partnership after June 8, 1997, this is the amount of net gain (that is, gain reduced by any loss) that the distributee partner would be required to recognize under IRC section 704(c)(1)(B) if all property owned by the partnership immediately before the distribution that had been contributed by the distributee within 7 years of the distribution were distributed to a partner other than the contributing partner.

Noncontributing partner

Any partner who does not contribute a particular asset with a built-in gain or a built-in loss to the partnership.

Non-exempt assets

Assets of the debtor which must become a part of the bankruptcy estate.

Non-recourse

Debt for which no taxpayer is personally liable.

Nonpartnership item

Any item that is (or is treated as) not a partnership item. IRC section 6231(a)(4).

Non-recourse debt

A liability for which no partner bears the economic risk of loss.

Non-recourse liability

A liability for which no partner bears the economic risk of loss.

Non-TEFRA partnership

A partnership not governed by the above statutory provisions and accompanying regulations.

Normal distribution

Periodic distributions to partners that are presumed not to be disguised sales, including distributions of normal operating cash flow, reasonable guaranteed payments, and preferred returns, intended to compensate partners for the use of their capital.

Notice of Inconsistent Treatment

A notice by a partner indicating that the partner is claiming partnership items inconsistently with how the items are reported on the partner's Form K-1 or the partnership return.

Optional basis adjustments

Adjustments to the basis of partnership property under IRC sections 743 and 734, which are only made if there is an IRC section 754 election in effect.

Organization costs

Organization costs include the legal and accounting costs necessary to organize the partnership, facilitate the filings of the necessary legal documents, and other regulatory paperwork.

Outside Basis

The basis that the partner has in his/her partnership interest.

Partial liquidations

Distributions which result in a reduction, but not entirely, of a partner's interest in the partnership.

Partner non-recourse debt

A non-recourse loan that a partner or a related person makes to a partnership, where the economic risk of loss for the liability is not borne by another partner.

Partnership agreement

Any agreement that has an impact on the economic sharing arrangement among the partners or between one or more partners and the partnership.

Partnership debt

A liability of the partnership rather than of any individual partner.

Partnership item

Any item required to be taken into account for the partnership's taxable year under subtitle A of the Internal Revenue Code to the extent regulations provide that the item is more appropriately determined at the partnership level than at the partner level. IRC section 6231(a)(3).

Partnership minimum gain

The total amount of gain that the partnership would realize if it disposed of each property subject to a non-recourse liability for no consideration other than full satisfaction of the liability.

Partnership proceeding

A proceeding conducted under the unified partnership audit and litigation procedures contained in IRC sections 6221 through 6234.

Pre-contribution built-in gain or loss

Any gain or loss contained in property when the property is contributed to the partnership.

Primary economic effect test

A mechanical test for determining whether the allocation of a tax item of the partnership has economic effect that requires the partnership to maintain capital accounts in accordance with the rules of Treas. Reg. section 1.704-1(b)(2)(iv), and to use such accounts in determining the partners' rights and responsibilities when the partnership is liquidated. This test requires all partners to have an unconditional deficit restoration obligation.

Private foundation

An organization defined in IRC section 509**.**

Prompt Assessment

A request by the trustee under Bankruptcy Code section 505 (b).

Proportionate Distributions

A prorata distribution of the partnership's assets, that is, each partner's share of hot and cold assets remain unchanged by the distribution.

QRPBI -(Qualified Real Property Business Indebtedness)

Indebtedness which was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and with respect to which the taxpayer makes an election.

Qualified acquisition indebtedness

Indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Qualified income offset

A provision in a partnership agreement that requires that a partner who receives an unexpected adjustment, allocation, or distribution must be allocated items of income and gain in order to eliminate a deficit balance in the partner's capital account.

Qualified low-income building

Any building which is part of a qualified low-income housing project at all times during the compliance period.

Qualified/nonqualified liability

A non-qualified liability is a liability incurred within 2 years of a transfer and the proceeds of which were neither used to acquire or improve the contributed property, nor incurred in the ordinary course of a business and substantially all of the business assets are transferred. Qualified liabilities are all liabilities that are not nonqualified.

Qualified non-recourse financing

Certain non-recourse, nonconvertible debt borrowed in connection with the holding of real property, from certain persons regularly engaged in the lending business and secured by the property.

Reaffirmation

An agreement to continue paying a debt, generally a secured debt, even though you could receive a discharge of the debt in bankruptcy. Generally a debtor will reaffirm a debt in order to keep the asset which secures it.

Recourse liability

A liability for which a partner bears the economic risk of loss.

Remedial allocation method

A method of allocating tax items in order to take into account the built-in gain or built-in loss in contributed assets that requires tax allocations of "fictional" or "notional" income, gain, loss, or deduction in order to correct distortions created by the ceiling rule.

Revaluations

A recomputation of the partnership's book value of assets to reflect the fair market value. A partnership is permitted to do this in certain instances under Treas. Reg. section 1.704-1(b)(2)(iv)(f).

Sale or exchange of a partnership interest

A transaction in which a partner transfers all or a portion of his interest in a partnership in exchange for something of value.

Security agreement

An agreement whereby a person pledges assets as security for a loan. In general, a partner is treated as bearing the economic risk of loss for a partnership liability that is secured by the partner's pledge of assets to the extent of the fair market value of the security.

Security Trader

Someone who buys and sells securities with reasonable frequency in the hopes of catching the swings in the daily market and profits on a short-term basis.

Sham in fact

A transaction that never actually took place.

Sham in substance

A transaction that actually took place but which lacks the economic reality that the form purports to represent.

Shifting allocations

Allocations in a single year that reduce the partners' overall tax liabilities in a given year without substantially altering the net increases or decreases that would be recorded in the partners' capital accounts without the allocations.

Start-up expenses

Expenses incurred or paid for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up expenses also include any amounts paid or incurred in connection with any activity engaged in for profit or for the production of income before the trade or business begins, in anticipation of the activity becoming an active trade or business.

Step transaction

Collapsing a series of transactions into a single transaction in order to determine the correct federal income tax consequences.

Substance over form

The judicial doctrine that looks beyond the form to the substance of a transaction for determining the proper tax treatment of the transaction.

Substance versus form

The judicial doctrine that looks beyond the form to the substance of a transaction for determining the proper tax treatment of the transaction.

Substantial economic effect

A detailed, two-part test in Treas. Reg. section 1.704-1(b)(2) for determining whether an allocation is respected. To be respected, the allocation must meet the economic effect test and the substantiality test.

Substantiality

An allocation is substantial if there is a reasonable possibility that it will affect the dollar amounts that partners will receive from the partnership, independent of tax consequences.

Suspended loss

Any amount, not currently allowed, of a partner's share of partnership loss due to either the basis, at risk, or passive loss limitations.

Suspended passive activity loss

A loss sustained by the partnership and allocated to the partners, but not allowed to a passive partner until the partner has passive income or disposes of the passive activity.

Syndication expenses

The costs of syndicating a partnership and its related investment units.

Tax capital accounts

Accounts that reflect each partner's share of the partnership's inside basis that is useful for keeping track of the allocations required by IRC section 704(c).

Tax indifferent partner

A partner such as a foreign taxpayer not subject to U.S. tax, an exempt organization, an insolvent taxpayer, a taxpayer with unused losses or credits. Existence of a tax indifferent partner is one factor which may indicate a disregard for Subchapter K. See Treas. Reg. section 1.701-2(c).

Tax Matters Partner ("TMP")

The general partner designated or selected as tax matters partner as provided in the regulations. IRC section 6231(a)(7). In limited circumstances the Service may select a limited partner as TMP.

Tax Shelter

Any partnership or other arrangement a significant purpose of which is the avoidance or evasion of federal income tax.

TEFRA partnership

A partnership subject to the unified partnership audit and litigation procedures contained in IRC sections 6221 through 6234.

TEFRA statute of limitations

The minimum period for assessment for partnership items set forth in IRC section 6229.

Termination

This event is deemed to occur under IRC section 708(b)(1)(B) when there has been a sale or exchange of 50 percent or more of the total interests in partnership capital and profits within a 12-month period.

Traditional method

A method of allocating tax items in order to take into account the built-in gain or built-in loss in contributed assets. Under the traditional method, the total income, gain, loss, or deduction allocated to the partners with respect to a property cannot exceed the total partnership income, gain, loss or deduction with respect to that property for the taxable year (the ceiling rule).

Traditional method with curative allocations

A method of allocating tax items in order to take into account the built-in gain or built-in loss in contributed assets that requires tax allocations of actual partnership income, gain, loss, or deduction that differ from the partnership's book allocation in order to correct distortions created by the ceiling rule.

Transitory allocations

Offsetting allocations in multiple years that reduce the partners' overall tax liability in a given year without substantially altering the net increases or decreases that would be recorded in the partners' capital accounts without the allocations.

Unrealized receivables

Amounts due to be received for goods delivered or to be delivered, to the extent the amount would be treated as ordinary income or for services rendered or to be rendered. Also includes depreciation recapture and similar items for purposes of determining the character of gain or loss upon the sale or exchange of a partnership interest. A type of IRC section 751(a) property.

Value-equals-basis rule

A presumption made in determining whether an allocation is transitory. The rule presumes that an asset's value is equal to its basis.

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Ten Core Ethical Principles*

Honesty
Integrity/Principled
Promise-Keeping
Loyalty
Fairness
Caring and Concern for Others
Respect for Others
Civic Duty
Pursuit of Excellence
Personal Responsibility/Accountability

The Five Principles of Public Service Ethics*

Public Interest
Objective Judgment
Accountability
Democratic Leadership
Respectability

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