Partnership & LLC Taxation – Advanced Issues

(PTAI)

KAPLAN

Partnership & LLC Taxation—Advanced Issues

(PTAI)

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PARTNERSHIP & LLC TAXATION—ADVANCED ISSUES (PTAI)
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Unit 1

Overview of Partnership & LLC Rules

LEARNING OBJECTIVES

- **Understand** the options for elective classification of entities under the "Check theBox" regulations.
- **Determine** the importance of the determination of whether an entity is treated as atax partnership and those entities eligible to elect out of suchtreatment.
- **Understand** the nature of the entity and aggregate theories of taxation and the impact of each.
- **Determine** the unique nature of limited partnerships and other limited interest entities, aswell as issues arising from the definition of a limitedpartner.

CLASSIFICATION OF PARTNERSHIPS

IRC Section 7701(a)(2) defines the term *partnership* to include the following:

A syndicate, group, pool joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation. . . .

Section 7704 provides that publicly traded partnerships will be treated as corporations for tax purposes. A "publicly traded partnership" is one whose interests are traded on an established securities market or are readily tradable on a secondary market or its equivalent. There is an exception if 90% or more of the partnership's gross income is from passive sources such as interest, dividends, real property rents, and income from natural resources. This basically applies to partnerships that could be investment companies under IRC Section 851

Husband & Wife Joint Entities: Community Property States

Community property states created a potential issue for single member LLCs created by a person married or otherwise subject to community property rules in states with those rules. Most property held in such states is deemed to be held by the community in which each member has a ½ interest. Thus, such an entity would have two owners, technically creating a partnership.

In Rev. Proc. 2002-69, the Service ruled that a husband and wife who own 100% of an unincorporated entity in a community property state may treat the entity as either a disregarded entity or a partnership. This means its income can be reported either in a 1040 or a 1065. Changing the reporting method after the initial return is filed will be considered a conversion of the entity's status.

The community property states are Idaho, Washington, California, Nevada, Arizona, New Mexico, Texas, Louisiana, and Wisconsin. Some of these states grant community property treatment to registered domestic partners. The IRS has indicated in its list of frequently asked questions related to registered domestic partners that Rev. Proc. 2002-69's choice of entity option does not apply to a couple unless they are treated as married under federal law.

Advisers must realize that not all property held by a married couple in a community property will be community property and that the rules are different in each of the individual community property states. Advice from counsel skilled in community property law for the state in question should be sought if there is any doubt whatsoever regarding the status of the interest in question.

Qualified Joint Ventures (IRC Section 761(f))

The Small Business and Work Opportunity Tax Act of 2007 attempted to extend the treatment found in Rev. Proc. 2002-69 to all married couples. If a husband and wife conduct a qualified venture and file a joint return, the joint venture isn't treated as a partnership for tax purposes (IRC Section 761(f)). Thus, no Form 1065 is required. A qualified joint venture is the conduct of a trade or business where only a husband and wife are partners or members, both materially participate under the passive loss rules without regard for the rule that treats one spouse's participation as participation by the other spouse, and both spouses elect this special treatment. If this election is made, both spouses must compute self-employment income on their share of the venture's income. If the election is made, the venture income will be deemed to be earned by each spouse as a sole proprietor and thus reported on the appropriate individual tax form (i.e., Schedule C, F, etc.).

Making the Election

The election is made simply by filing a return reporting the income for each spouse separately—dividing the income and expenses based on the spouse's relative ownership in the entity—per the election page on the IRS website.

How does a couple who previously filed a partnership return and now has made the election to file as a qualified joint venture handle an inquiry from the IRS about the partnership return? The answer is easy, according to the IRS. Just call the toll-free number that is shown on the notice and advise the telephone assistor that the couple reported the income on their jointly-filed individual income tax return as a qualified joint venture. Alternatively, the spouses can write the IRS and provide the same response.

Changing the Election

The IRS position, not yet set forth in any official guidance such as a revenue ruling or revenue procedure, is that once taxpayers file as a qualified joint venture, that election can only be revoked with the IRS's consent. Thus, we find the first major difference between the treatment for qualified joint ventures and that given to community property entities where status may be changed without the IRS's consent.

As a practical matter, though, the election will terminate if the spouses fail to meet all of the requirements of being a joint venture (i.e., both spouses don't materially participate) for a year. In that case, a new election must be made.

Reporting for a Qualified Joint Venture

Unfortunately, the procedures required for a qualified joint venture to file a return are relatively cumbersome, requiring separate Schedule Cs, Schedule Es, or both. While the option seems initially to offer relief from the time and expense necessary to prepare a Form 1065, the more complicated reporting on the Form 1040 has caused many practitioners to discover that the supposed time and cost savings are illusory in many cases.

Note that for those in community property states, reporting under Rev. Proc. 2002-69 does not appear to require this level of complexity. Thus, in those circumstances that meet the Rev. Proc. 2002-69, some real administrative time-savings really may be available. As well, Rev. Proc. 2002-69 clearly applies if the husband and wife hold the property in a disregarded entity, while, as noted previously, the IRS has taken the position that such entities cannot be qualified joint ventures.

However, this does mean that IRC Section 761(f) appears to fall short of providing "parity" for those not holding property in community property ownership—an option not available in the vast majority of states.

Treatment of Limited Liability Companies

There is a major potential problem here, though. The IRS position, found at https://www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses, is that if any "legal" entity exists, such as a general partnership or an LLC, the qualified joint venture election isn't available.

In a surprise, the IRS concludes in the information on its website that "only businesses that are owned and operated by spouses as co-owners (and not in the name of a state law entity) qualify for the election." Thus, according to the IRS, LLCs, limited partnerships, and conceivably even general partnerships that have been formed by a husband and wife are precluded from making this election.

In short, the IRS appears to be limiting the benefit of this provision to "informal entities." Whether this is what Congress intended is the subject of a great deal of controversy.

The fact that Rev. Proc. 2002-69 allows for LLCs to be treated as "not partnerships" is reiterated on the same website, referring couples who discover their LLC cannot be a qualified joint venture that they should take a look at that revenue procedure if the interest is held as community property.

Rental Properties

There is some controversy over whether the election can apply to rental properties reported on Schedule E of Form 1040. The statutory language isn't clear and there has yet been no formal guidance on whether such an election is possible. However, in an Internal Legal Memorandum (ILM 200816030), the IRS concluded that a married couple, otherwise qualified to make an election to treat rental real estate income as a qualified joint venture, wouldn't have to report the net income as subject to the self-employment (SE) tax because IRC Section 1402(a)(1) would exclude that income from SE taxation. The ILM also concluded that the purpose of the qualified joint venture election was to ease reporting requirements, not to convert non-SE income to SE income.

The ILM recommended that the Service Centers be instructed to appropriately apply the SE provisions to rental real estate reported on Schedule C, rather than on Schedule E as the qualified joint venture (QJV) instructions direct. Thus, it does appear that substantial authority for such a position exists.

CHECK-THE-BOX REGULATIONS

IRC Section 7701(a)(3) provides that a corporation includes "associations, joint-stock companies, and insurance companies." This broad definition has resulted in entities being taxed as a corporation even though they are not considered corporations under applicable state law. It is also possible for an entity classified as a corporation under state law to be taxed as a partnership for Federal income tax purposes.

Generally, the law mandates that certain state law entities be treated as corporations, most notably an organization that is organized under state corporate law statutes. For those entities that are not automatically treated as a corporation, trust, or estate, the regulations provide rules commonly referred to as the "check the box" rules.

"Check-the-Box" Elections Overview

A business entity that is not classified as a corporation can elect its classification for federal tax purposes (e.g., a corporation, a partnership, or an entity disregarded as separate from its owner).

Under the check-the-box elections, an entity may elect initially to be classified other than its default classification as provided in Treas. Reg. Section 301.7701-3(b) or can change its classification by filing Form 8832. Such an election cannot take effect more than 75 days prior to the date the form is filed, nor can it take effect later than 12 months after the election is filed.

The Regulations—Check the Box

Regulation Section 301.7701-2 maintains the distinction between trusts and business entities by the associates and profit motives. Once an entity is classified as a business entity, the regulations specify entities that are automatically classified as associations. These include corporations created under a state's corporate statute, state law joint stock companies, insurance companies' state or federally chartered banks, an organization under a statute of a federally recognized Indian tribe, and those entities treated as such under other provisions of the code, such as publicly traded partnerships and taxable mortgage pools.

Regulation Section 301.7701-3 allows any business entity with at least two members to be classified as either a partnership or an association (which is taxed as a corporation), while a business entity with a single owner can elect to be classified as either a disregarded entity or an association. However, the default treatment that takes place if an entity does not make an explicit election is different for domestic and foreign entities.

Domestic Entities

Absent an election, a domestic entity with two or more owners is classified as a partnership (Reg. Section 301.7701-3(b)(1)(i)). Accordingly, if such a business entity wants to be taxable as a corporation, it must elect such treatment. Further, assuming all of the other requirements to make an

S election are met, the business entity can elect to be taxed as a corporation and then make an S election.

Since two members are required for an entity to be taxed as a partnership, a single member business entity is either an association or a disregarded entity. A disregarded entity generally is given no independent tax significance.

Thus, a sole proprietorship formed as a single member LLC still reports its income or loss on the owner's Schedule C. Likewise, the income and expenses of a single member LLC owned by a corporation are included in the corporation's income and expenses. However, the disregarded entity is treated as a separate entity for employment tax and certain excise tax provisions.

If no election is made, a domestic single owner entity will be treated as a disregarded entity (Reg. Section 301.7701-3(b)(1)(ii)).

Foreign Entities

The regulations provide that foreign entities will be classified as associations (i.e., treated as corporations) if all members have limited liability (Reg. Section 301.7701-3(b)(2)(i)(B)). If there are two or more members and any member has unlimited liability, then it is classified as a partnership unless it elects to be treated otherwise (Reg. Section 301.7701-3(b)(2)(i)(A)). If there is limited liability for all members, it will be an association unless an election is made to be treated as a partnership. A foreign entity that is unsure of its status under local law should be sure to file an election to protect its classification.

Election to Be Taxed as a Corporation

The election to be treated as an association taxed as a corporation is to be made on Form 8832. A copy must be attached to the first return filed. If the entity isn't required to file a return, Form 8832 must be attached to the returns of all direct and indirect owners of the entity. It is to be made by the entity and signed by an authorized member or by all members at the time the election is made. The election will be valid for the current tax year if made within the first 75 days; otherwise, it is valid for the next year. The form is to be filed with the Service Center where the entity files its return.

Unanimous consent of the members is not needed (Reg. Section 301.7701-3(c)).

In Rev. Proc. 2009-41, discussed later, the IRS provided a procedure for making a late election. Also, in Rev. Proc. 2004-13, the IRS included the filing of Form 8832 on the list of time-sensitive actions that may be postponed if the entity is affected by a presidentially declared disaster, a terrorist action, or a military action.

If an entity changes its status, it cannot change again for 60 months. The initial election is not a change and, thus, a new entity may change its mind. A waiver is available where there is a 50% change in ownership.

If an entity is terminated as a result of the rules of Section 708, the resulting entity will be classified as a partnership. The 2017 Tax Cuts and Jobs Act eliminated the long-standing rule formerly found in Section 708 which terminated the partnership with a change in ownership of 50% or more.

States have reacted differently to the regulations. As well, some states (notably California) may impose additional taxes or fees upon entities structured as an LLC even if taxed as a pass-through for general income tax purposes. Advisers should always make inquiries as to applicable state tax laws.

Form **8832**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

► Information about Form 8832 and its instructions is at *www.irs.gov/form8832*.

OMB No. 1545-1516

Type or Print

Name of eligible entity making election | **Employer identification number**

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.

► Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

Part I Election Information

1 **Type of election** (see instructions):

a ☐ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
b ☐ Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☐ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

a Name of owner ► ____________
b Identifying number of owner ► ____________

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

a Name of parent corporation ► ____________
b Employer identification number ► ____________

For Paperwork Reduction Act Notice, see instructions. Cat. No. 22598R Form **8832** (Rev. 12-2013)

Part I **Election Information** (Continued)

6 **Type of entity** (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
b ☐ A domestic eligible entity electing to be classified as a partnership.
c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
e ☐ A foreign eligible entity electing to be classified as a partnership.
f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ► ____________

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . ► ____________

9 Name and title of contact person whom the IRS may call for more information	**10** Contact person's telephone number

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title

Part II **Late Election Relief**

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I (we) further declare that I (we) have personal knowledge of the facts and circumstances related to the election. I (we) further declare that the elements required for relief in Section 4.01 of Revenue Procedure 2009-41 have been satisfied.

Signature(s)	Date	Title

Election to Be Treated as an S Corporation

Once an election to be treated as a corporation is made, the entity will file an 1120 and be subject to all of the rules of Subchapter C. However, an election can be made to be taxed under Subchapter S by simply filing Form 2553 instead of Form 8832. The timely filing of Form 2553 will make a deemed election to be treated as a corporation so long as the entity is eligible to make a valid S election at the time the form is filed (Reg. Section 301.7701-3(c)(1)(v) (C)).

Qualification Issues

Care must be taken to make sure that the operating agreement does not provide for allocations that could be construed as a second class of stock. For federal income tax purposes, "stock" in the LLC is referenced by the rights of each proportionate "unit" of ownership interest in the LLC. Each owner must have identical (i.e., proportionate) rights to distributions from the S corporation and for any eventual liquidating distributions in order to be treated as having a single class of "stock" under the S corporation regulations. However, the interests are allowed to have different voting rights and, therefore, rights to participate in management (Reg. Section 1.1361-1(l)(1)).

Additionally, the entity must continue to qualify as an S corporation (i.e., no more than 100 shareholders, maintain one class of stock, etc.) throughout the life of the entity or lose its S status. In Rev. Proc. 2007-62, the IRS provided a very liberal relief provision for corporations failing to timely file an S election for reasonable cause.

Ownership of or by a Disregarded Entity

If an S corporation owns an LLC that is disregarded and that entity owns another S corporation, the parent S can elect QSUB (Qualified Subchapter S Subsidiary) treatment for the corporation owned by the LLC.

EXAMPLE

Disregarded Entity as S Corporation Shareholder

Luskey Corp., an S corporation, is the sole member of an LLC organized under the laws of New York. The LLC owns all of the stock of Koepke Corp., a New York corporation. If the LLC is treated as disregarded, then Luskey Corp. may elect to treat Koepke Corp. as a QSUB. The result is that both the LLC and Koepke Corp. will be treated as divisions of Luskey Corp. and all results of operations will be picked up at the Luskey Corp. level.

An S corporation can also hold 100% of the interests in an LLC and treat that entity as disregarded. This can serve as a simpler alternative to using a QSUB so long as legal counsel is comfortable with the liability protection provided by the LLC under applicable law as compared with protections that are available for a corporation. Such a determination is a legal—not tax—determination, and tax advisers who are not licensed attorneys should refer clients to such counsel to make these decisions.

S corporation shares may be held by an LLC so long as that LLC is a disregarded entity that is treated as wholly owned by a qualified S corporation shareholder. However, if that LLC has an interest acquired by a second party, then the S corporation election of the entity whose shares it holds will terminate, since neither a partnership nor a C corporation can hold S corporation shares. Only if that

LLC holds 100% of the S corporation's shares and makes its own S election, followed by a QSUB election for the subsidiary, could the S status be retained.

Procedures for Late-Filing Relief

Rev. Proc. 2009-41 provides automatic late entity classification relief under Section 7701 to both initial classification elections and changes in classification elections in certain cases. Under the procedure, relief is requested by filing Form 8832, Entity Classification Election; a required declaration of eligibility; and a reasonable cause statement with the appropriate IRS Service Center.

Entities are eligible for relief under the provisions of this revenue procedure if they meet the following four requirements:

- The entity failed to obtain the desired classification for either of the following reasons.
  - An initial classification or a newly-formed entity failed to obtain desired classification because Form 8832 was not timely filed under Treas. Reg. Section 301.7701-3(c)(1)(iii).
  - A requested change in classification was not made solely because Form 8832 was not timely filed under Treas. Reg. Section 301.7701-3(c)(1)(iii).
- The entity meets the appropriate tax filing eligibility requirements.
  - The entity has not filed a federal tax return for the first year in which the election was intended to be effective because the due date has not passed.
  - The entity timely filed all required federal tax returns and information returns consistent with its requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the taxable years.
- The entity has reasonable cause for its failure to timely make the check-the-box election. (See the discussion on the reasonable cause statement.)
- Three years and 75 days from the requested effective date of the eligible entity's classification election have not passed.

An entity that does not satisfy the requirements for automatic relief under Rev. Proc. 2009-41 may request Reg. Section 301.9100-3 relief by applying for a letter ruling and paying the appropriate fee. Such relief is regularly granted so long as the taxpayer files a request for such relief prior to an IRS examination.

A taxpayer who wished to have an LLC or similar entity treated as an S corporation has to recognize there are two late elections involved, even though only a single form (Form 2553) was not filed.

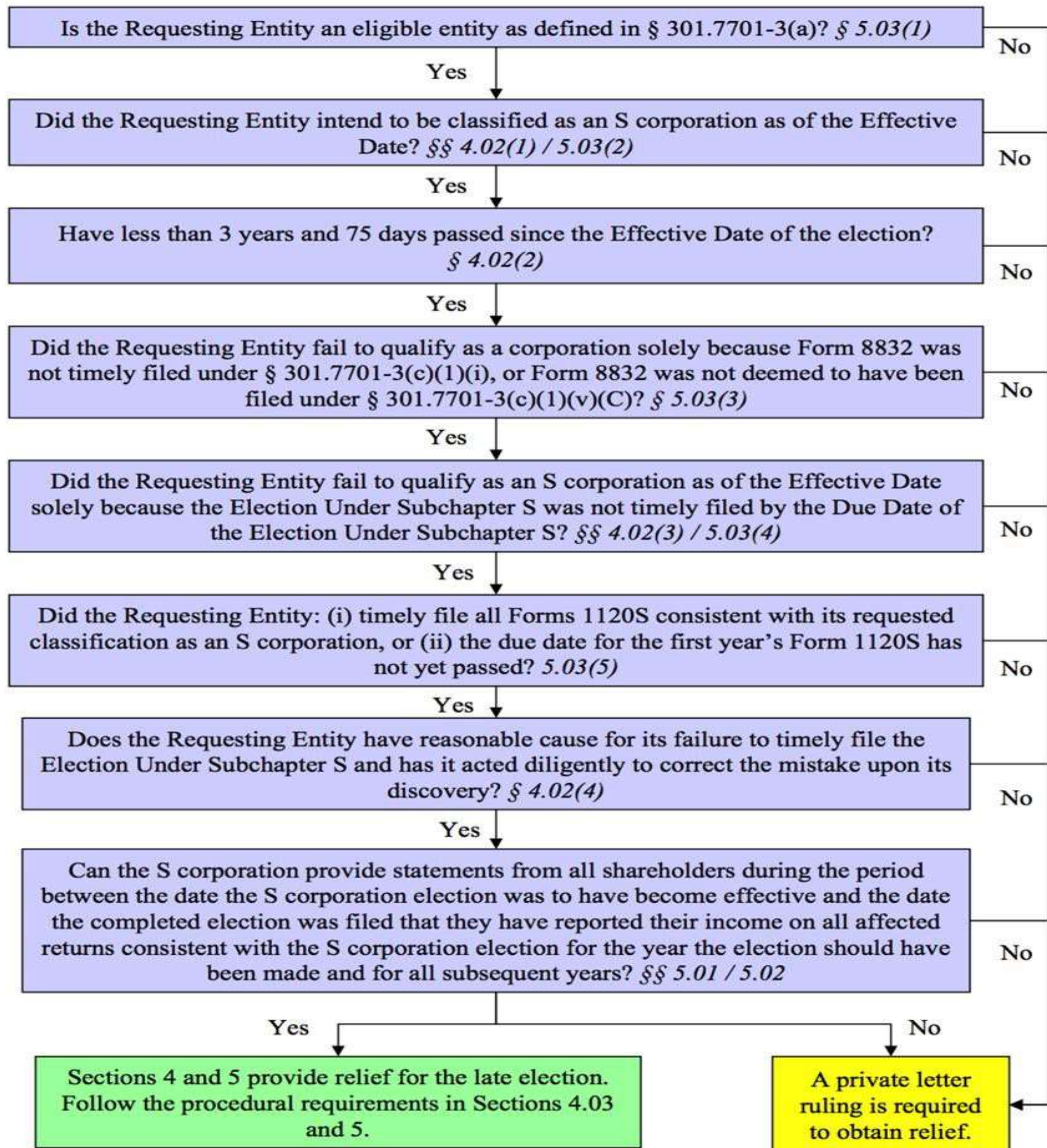
While Rev. Proc. 2009-41 can provide for late filing relief in electing to become a corporation, it cannot solve the problem of the late S election.

In this situation, the entity must initially look to Rev. Proc. 2013-30 to remedy the situation. To be eligible in this case:

- the entity must show reasonable cause for the filing;
- must have failed to obtain corporate status solely due to having failed to file an entity election timely;
- must have failed to obtain S status solely due to having failed to file a Form 2553 on time;
- all taxpayers must have reported consistently as if the election had been properly made; and
- the relief is requested within three years and 75 days of the date the entity wished both the corporate status and the S election to take effect.

In this procedure the IRS consolidated and simplified the options for automatic permission to file a late S corporation election. Of interest to taxpayers who formed an LLC, a procedure is provided for the case where the S corporation in addition failed to make an entity election to be treated as a corporation.

The ruling provided the following flowchart that explains which entities qualify for this relief and the steps that must be taken.



Entities that cannot obtain automatic relief will need to pursue a private letter for late election relief under the general late regulatory election relief provisions of Reg. Section 301.9100-3. To request such relief, a user fee will generally need to be paid, and significant professional assistance will most often be needed.

OTHER ENTITY CLASSIFICATION

The check-the-box regulations did not eliminate all questions on entity determination. Some of these issues are discussed in the following sections.

Basic Definition of a Partnership

It is clear that the arrangement must involve two or more persons carrying on a business and dividing the profits therefrom. The intent of the parties is the key factor (*Commissioner v. Culbertson*, 337 U.S. 733 (1949)). This is inherent in the check-the-box regulations. Profit motive is the crucial factor (*Ian Allison v. Commissioner*, 35 T.C.M. 1069 (1976)).

However, there have been arrangements classified as partnerships without profit motive. In PLR 7903084, the Service held that an arrangement between co-owners of oil spill and containment equipment was a partnership even though the arrangement was deemed to lack a profit motive. This type of entity was a not-for-profit entity that did not fit any specific classification. This should be compared to PLR 9108025, where the Service classified a trust as a partnership since it found a profit motive to exist.

Other Factors Indicative of a Partnership

Other factors include sharing of losses, joint ownership of capital, joint participation in management, and contribution of services. If there is joint ownership of income-producing capital, the enterprise most likely will be a partnership unless there is strong evidence that the "jointness" is limited in nature and the parties are mere co-owners. This has often been applied to ownership of rental property by co-owners.

Rev. Rul. 75-374 sets forth the characteristics the Service is looking for to classify co-ownership as a partnership—the basic factor is the intent to form a partnership. In *Jerome J. Roubik v. Commissioner*, 53 T.C. (1969), the court found that two persons owning a plane jointly carrying on separate businesses were not partners because they lacked the intent to be anything other than mere co- owners.

Parties who file a partnership return have generally been unsuccessful in later claiming a partnership did not exist.

The interests in the entity must be proprietary and envision the sharing of net profit, not gross profit. In addition, a proprietary interest contemplates the sharing of venture losses as well as profits, although this alone will not be fatal to the classification as a partnership (*Huber M. Luna v. Commissioner*, 42 T.C. 1067 (1964); *Lamar Hunt v. Commissioner*, 59 T.C.M. 635 (1990)).

If the arrangement is deemed not a partnership, income from it still must be characterized. Thus, a share of gross profit from a venture may be compensation for the use of property (rent), money (interest), or service (commission).

ELECTING OUT OF PARTNERSHIP TREATMENT (IRC SECTION 761(A))

Under IRC Section 761(a), some partnerships can elect to be excluded from the application of Subchapter K. This election is available only if the entity is a general partnership.

While there is a formal election to be made within the filing time for the first partnership return, there is a catchall (dumb but lucky) provision that allows the election if at all times it appears the intent was to make an election. If made, each person is responsible for income, et cetera, on a separate accounting concept.

Entities Eligible for Election

There are three types of arrangements eligible to elect out of Subchapter K:

- Investment only and not conducting an active business
- Joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted
- Dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities

In order to qualify, the arrangement must be such that each person may adequately compute his income without a computation of "partnership income."

Why elect out of partnership treatment? There are a number of benefits. First, since each individual is treated separately, there is no requirement that all use the same method of accounting as there would be if a partnership existed. Also, each owner would be entitled to make separate elections for such things as depreciation methods, capitalization of intangible drillings costs, et cetera.

Making the Election

As noted earlier, an election out of partnership tax treatment is made in one of two ways.

The best way is to file a Form 1065 for the first year a return would be due. The partnership doesn't have to complete Form 1065, but it must include the name and address of the entity and must also:

- state that the organization qualifies as an investing partnership, operating agreement group, or securities syndicate;
- state that all members elect to be excluded from all partnership provisions;
- state where a copy of the agreement under which the organization acts is available. If the agreement is oral, state from whom the provisions can be obtained;
- list the names, addresses, and EINs of all members of the organization; and
- the election must be filed timely (including extensions), for the first taxable year for which the election could be effective (Reg. Section 1.761-2(b)(2)).

The second method is the "deemed election" method, also known as the "dumb but lucky" method. Here, no election is filed (possibly because the organization didn't think about making the election). Under this alternative, the organization will have been deemed to elect out of the partnership provisions if it can be shown from all the facts and circumstances that all of the members of the organization intended to elect out of the partnership rules on the formation of the organization.

One of two facts can demonstrate this.

- At formation, there was an agreement among the members that the organization be excluded from the partnership provisions.
- The members of the organization owning substantially all of the capital interests report the organizations, income, deductions, etc., in a manner consistent with electing out of the partnership provisions, starting with the first taxable year of the organization.

Once made, the election out of the partnership provisions is irrevocable (unless the IRS consents to a revocation) so long as the organization remains qualified as an investing partnership, operating group agreement, or securities syndicate (Reg. Section 1.761-2(b)(3)).

TENANCY IN COMMON VS. PARTNERSHIP

In recent years, the ownership of real estate as tenants in common has become very popular. When property is held as tenants in common, each owner holds an undivided right to her proportionate share of the income and is responsible for her proportionate share of any expenses. The individual owners can do whatever they like with their share of the property, including selling it or exchanging it without the consent of any of the other owners.

EXAMPLE

Tenancies in Common

Stuart buys a 25% interest in Blackacre, a piece of land being used for gardening. Total income from the rental of garden spaces is $10,000. Real estate taxes and the insurance expense are $4,000. Stuart will receive $2,500 in rental income ($10,000 × 25%) and will be responsible for paying $1,000 of the expenses ($4,000 × 25%).

Revenue Procedure 2002-22

There were significant questions about the tax treatment of such arrangements, particularly in how the IRS would attempt to classify such transactions. For years, the IRS resisted ruling on these questions. Finally, in Rev. Proc. 2002-22, the IRS laid out the guidelines for issuing a ruling on the tax treatment of tenants in common situations. In seeking a ruling in this area, however, caution should be exercised, since the IRS has reserved the right not to rule—in short "if we don't like what you're doing, we won't rule, but we will probably send the ruling request to the area director for audit consideration."

As well, the ruling lists 15 conditions that must exist in order for a ruling request to be considered. Advisers have reported that, as a practical matter, examining agents have been using this list of required conditions to ask for a ruling as a list of requirements that must be always be satisfied in order for a tenancy in common interest not to be treated as an interest in a partnership.

The following is the language from the ruling that outlines the 15 conditions imposed by the IRS.

1. Tenancy in Common Ownership

   Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

2. Number of Co-Owners

   The number of co-owners must be limited to no more than 35 persons. For this purpose, "person" is defined as in Section 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person

3. No Treatment of Co-Ownership as an Entity

   The co-ownership *may not file a partnership or corporate tax return*, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The Service generally will not issue a ruling under this revenue procedure if the co-owners held interests in the Property through a partnership or corporation immediately prior to the formation of the co-ownership. (emphasis added)

4. Co-Ownership Agreement

   The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see Section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section of this revenue procedure for conditions relating to voting).

5. Voting

   The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this Section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

6. Restrictions on Alienation

   In general, each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the Property without the agreement or approval of any person.

   However, restrictions on the right to transfer, partition, or encumber interests in the Property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited. See Section 6.14 of this revenue procedure for restrictions on who may be a lender. Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the Property. In addition, a co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

7. Sharing Proceeds and Liabilities upon Sale of Property

   If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

8. Proportionate Sharing of Profits and Losses

   Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner's undivided interest in the Property.

   Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

9. Proportionate Sharing of Debt

   The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

10. Options

    A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

11. No Business Activities

    The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75- 374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in Section 511(a)(2) from

qualifying as rent under Section 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners.

For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

12. Management and Brokerage Agreements

The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See Section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

13. Leasing Agreements

All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See Section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.

14. Loan Agreements

The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property Payments to Sponsor.

15. Payment to Sponsor

    Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

Drop & Swap Transactions

A key reason for the IRS interest in this area is that while real estate interests held as tenancy in common can qualify for Section 1031 exchange treatment, taxpayers may not exchange partnership interests under the provisions of Section 1031. The 2017 Tax Cuts and Jobs Act generally repealed Section 1031 for all but real estate transactions. Even prior to the 2017 Tax Act, exchanges of partnership interest didn't quality. IRC Section 1031(a)(2)(D) prior to its repeal.

This leads to "drop and swap" transactions when partners do not agree to all participate in a new Section 1031 exchange when the partnership decides to dispose of property. A partnership can be a party to a Section 1031 exchange so long as it is exchanging qualified property. However, at times, some partners will want to cash out, or the partners will disagree on what property should be acquired to replace the one being disposed of.

So, the solution suggested is to "drop" the property out of the partnership and into a joint ownership structure, such as a tenancy in common. At that point, the partners can each exchange their proportionate interest for other property or simply cash out on the sale of the property (or at least that is the claimed result of the transaction).

The condition imposed at .03 of the ruling makes it clear the IRS does not generally believe that a drop and swap transaction should qualify for deferral. At the very least, the ruling suggests that the Service is very likely to challenge a taxpayer on an examination if the interest in property being exchanged was "dropped" to the taxpayer in the recent past.

AGGREGATE OR ENTITY: SUBCHAPTER K

A basic issue that is inherent in partnership taxation is the dichotomy between the two theories of partnership taxation: entity and aggregate. The entity theory is best characterized by the concepts of Subchapter C relating to corporations. The shareholders are considered to be separate and distinct taxpayers from the corporation they own. The corporation is a taxable entity under the Internal Revenue Code (IRC) and, thus, the issue of double taxation.

Nature of the Theories

Under the aggregate theory, the partnership is an aggregate of its owners, not separate and distinct. As an aggregate, it pays no tax and its owners pick up their proportionate share of partnership items of income, deduction, loss, and credit. These items are deemed incurred by the partners directly.

There is no double tax as the items of income, when actually received, are deemed to have been previously taxed to the same taxpayer. The partnership is but a mere conduit for tax reporting.

Subchapter K, the partnership rules, is a blending of these theories. The aggregate theory dominates the taxation of income to the partners and taxation of gain on contributions and distributions. The

entity theory dominates the treatment of transfers of interests, computation of partnership taxable income, adoption of years and methods of accounting, and the treatment of certain transactions between the partnership and its partners.

An example of the entity theory is the Supreme Court's decision in which partners were taxable on income that was contingent at the partner level but not contingent from the perspective of the entity. Sec. 702(b); Basye, 410 U.S. 441 (1973).

The rules can and often are intermixed in the determination of an item's tax treatment. For example, the entity theory is clear in the notion that each partner has a basis in his partnership interest that is separate and apart from his interest in the partnership's aggregate basis in partnership assets. Yet, the adjustments to basis reflect the aggregate theory of income and loss.

The blending of these theories adds much uncertainty to the whole body of partnership law. In any area not specifically covered by statute or regulation, which theory to apply becomes an important issue? This requires significant research and is usually resolved by analogy to other situations covered by the Code and Regulations.

Partnerships & Cancellation of Debt Exclusions

The tax treatment of partnerships in regard to the potential exclusions for cancellation of indebtedness under IRC Section 108 is an important area where the importance of the aggregate versus entity treatment becomes very clear. Section 108 follows the aggregate view of taxation of the partnership.

Under IRC Section 108(d)(6), the following provisions of Section 108 are applied at the partner rather than the partnership level:

- Exclusions under Section 108(a) (of key interest are bankruptcy and insolvency)
- Reduction of tax attributes under Section 108(b)
- Treatment of discharge of qualified real property indebtedness under Section 108(c)
- Treatment of qualified farm indebtedness under Section 108(g)

Of keen interest is the fact that qualification for the major components of Section 108 relief is tested at the partner rather than the partnership level. Quite often, this has a negative impact on the individual partner that may prove unexpected to those not aware of use of the aggregate view of taxation in this area.

EXAMPLE

ABC, LLC has three owners and invested in a piece of raw land, borrowing $1,000,000 to purchase the property. The land was not used for trade or business purposes, but rather was held with the hope of appreciation in value. Each of the equal partners put in $100,000 and the partnership paid $1,300,000 for the property. The debt is a recourse debt, but none of the partners signed on to guarantee the debt.

The hoped-for appreciation never occurred and the partnership ceased paying on the debt two years later when the land was worth $500,000, allowing the bank to take the property back. The property is treated as being sold for $500,000, resulting in a long-term capital loss of $800,000. The LLC had no other assets and the lender, therefore, wrote off the remaining balance of the debt.

Even though the LLC itself is insolvent, the members still receive their allocable share of the cancellation of indebtedness income ($166,667). Assuming the partner is solvent, the partner will report $166,667 of ordinary income along with a $266,667 long-term capital loss.

As well, if the taxpayer does qualify for relief under the insolvency exception, the taxpayer's own tax attributes will be subject to reduction.

LIMITED PARTNERSHIPS & LIMITED LIABILITY COMPANIES

Federal tax law defines entities broadly and does not attempt to exhaustively list and identify every type of entity that may be formed under local law. Rather, such entities must be classified to fit into the categories the tax law knows about.

Within the realm of partnerships, a number of special local law entity types need to be classified. In some cases, there will be a special federal treatment provided, while in others, we will need to fit the entity into a federal classification as a "partnership" or some special type of partnership that the law recognizes.

Limited Partnerships

Limited partnerships (LPs) were the vehicle of choice for many investment-related partnerships, especially in oil, gas, and real estate. Every state has adopted a form of the Revised Uniform Limited Partnership Act. The limited partners own units that take advantage of the flow-through aspect of partnership taxation. For tax purposes, it is a partnership. These limited partners have liability like a shareholder of a corporation—limited to their investment.

The law requires that someone be personally liable and that is the general partner. This liability is often shielded by the use of a corporate general partner. The downside for the limited partners is the lack of management rights. A limited partner may become personally liable as a general partner if the limited partner participates in the control of the partnership, leading an outsider to reasonably believe that the person is a general partner and the outsider has transacted business with the partnership with that belief. Certain activities of a limited partner will not constitute control, such as:

- being an agent, employee, or independent contractor of the LP or the general partner;
- being an officer, director, or shareholder of the general partner;
- acting as a surety or guarantor of a partnership obligation;
- pursuing a derivative suit on behalf of the limited partners;
- attending meetings of the partners;
- voting on matters allowed by law, such as dissolution, amendments to the partnership agreement, and admission or removal of partners; and
- assisting with winding up of the LP affairs as allowed by the Revised Uniform Limited Partnership Act.

LPs are referenced in the IRC, most notably in the areas of self-employment income under IRC Section 1402 and the passive activity provisions found at Section 469. However, federal law does not contain a definition of a "limited partnership" for these purposes. As we will discuss later, this has resulted in case law in both of these areas, as well as IRS proposed regulations in the passive activity area in response to the case law.

Limited Liability Company

A limited liability company (LLC) is an unincorporated entity with one or more owners, known as members. All states now allow for a single member LLC. Prior to check-the-box regulations, the specific wording of the LLC Articles was determinative of the tax status. Statutes have become free forms with terms such as "unless otherwise provided," allowing tremendous flexibility in the economic arrangement between the members and providing planning opportunities for owners.

Essentially, a multimember LLC is a partnership with limited liability for all partners. This provides a vehicle that overcomes the two major drawbacks to LPs: all members have limited liability and all members may participate in management without being subjected to personal liability.

LLCs were the driving force behind the issuance of the check-the-box regulations discussed earlier.

Limited Liability Partnerships

Every state recognizes a hybrid entity called a limited liability partnership (LLP). LLPs are not considered to be under the generic LLC laws and were generally provided through amendments to state partnership laws. Generally, these partnerships are for licensed professionals. Some states, such as New York, are very broad in providing protection against all liabilities except those of professional negligence or wrongdoing and the acts of those being supervised. Other states limit the partner's liability for torts but not for some liabilities arising from discrimination, RICO claims, contractual debts, or obligations.

In many cases, such entities were used to avoid having to reform an entity as an LLC, resulting in the writing of a new operating agreement. Many states allowed LLPs to be created without amending the underlying partnership agreement. Avoiding the drafting of a new underlying agreement was very important for large professional partnerships where such agreements were complex.

Application of Self-Employment Tax Provisions

Another issue that arises with regard to entity types is the application of the self-employment tax provisions of IRC Section 1402. Generally, under IRC Section 1402, a partner's distributive share of income or loss from a business carried on by the partnership, regardless of the individual partner's level of activity in the entity, is subject to self-employment tax (IRC Section 1402(a)). However, at IRC Section 1402(a)(13), an exception is carved out from this treatment for the income or loss of a limited partner other than guaranteed payments received for services.

While the check-the-box regulations described earlier tell us how to obtain partnership treatment for an LLC, LLP, or similar entity, the regulation is silent on whether the holder of an interest in an entity is or could be a limited partner for purposes of IRC Section 1402(a) (13).

In 1997, the IRS issued proposed regulations to deal with this issue, but the regulations were almost immediately subject to criticism, and Congress for a time forbade the IRS from making the regulations final. While that prohibition long ago expired, Congress has taken no action to clarify the

law since then and the IRS has left the regulations in proposed form, apparently preferring not to open the issue up again.

The IRS has, however, informally indicated on multiple occasions that they will not challenge a taxpayer that applies the proposed regulations.

Under those regulations, a taxpayer who is not a service partner in a service partnership will be treated as a limited partner unless at least one of the following three conditions applies to that partner.

- The taxpayer has personal liability for debts or claims of the entity by reason of being a partner.
- The taxpayer has authority to contract on behalf of the entity.
- The taxpayer participates in the entity's trade or business more than 500 hours during the partnership's tax year (Proposed Reg. Sections 1.1402(a)-2(h)).

Even if a taxpayer meets one of those three tests, the taxpayer can be treated as a limited partner with respect to a separate class of interest held by him if other partners who are treated as limited partners under the test hold a substantial, continuing interest in that second class of interests and the individual's rights with regard to that interest are identical to those other limited partners' rights.

As the regulations are merely proposed and suggest the test is not simply if the interest is an LP under state law, some have suggested alternative theories of treatment.

There was no real case law on the matter until 2011, when the Tax Court finally took up the matter in the published opinion issued in the case of Renkemeyer, Campbell, & Weaver, LLP v. Commissioner, 136 T.C. 137. In that case, the court rejected the taxpayers' theory that none of their income should be subject to self-employment tax as they (1) had limited liability and (2) had called themselves "limited partners" in the operating agreement.

Instead, the Tax Court looked at the level of activity of these partners in the partnership, concluding that what Congress was looking at when the provision was originally enacted was the level of involvement in the activity by the partners. As LLCs and the various similar entities did not exist at that time, the court concluded that an activity test should be used to determine whether a "partner" in such an entity would fall under the general rule of IRC Section 1402(a) (and thus be subject to self-employment tax on trade or business income) or be covered by the limited partner exclusion of IRC Section 1402(a)(13).

Note that the case's result roughly follows the result of the proposed regulations if they had been applied to this matter. However, the actual opinion is a bit more nuanced, with the court looking at whether the income arose as a return on the partners' investment or was from their services as attorneys in the law firm.

Similarly, the court did not posit a "hard and fast" 500-hour rule for such services that would trigger treatment of the member's income as self-employment income. And, arguably, the inclusion of the discussion of a return on investment in passing at the end of the opinion may leave open an argument for dividing their single interest into two separate interests and not imposing the tax on the "return on investment" portion if there was truly an argument for a true return on capital.

However, in a case citing the Renkemeyer decision, a U.S. District Court found that "for a taxpayer treated as a general partner, however, the distributive share of partnership income is subject to self-employment tax "irrespective of the nature of his membership," which suggests that no such split may be possible (*Riether v. United States*, 112 AFTR 2d 2013-6074 (DC NM, 2012)).

Service LLC Members May Have Issues Avoiding Self-Employment Income

Some additional guidance has emerged on the self-employment tax status of member-managers of an LLC in the case of *Castigliola, et al., v. Commissioner*, T.C. Memo 201762.

Like the members in the case of *Renkemeyer, Campbell, & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), the individual members in this case were attorneys who practiced in a law firm. However, unlike the attorneys in *Renkemeyer*, these attorneys did not claim that all income from the law firm was not subject to self-employment tax.

Rather, the attorneys had consulted with an experienced CPA well versed in tax matters and agreed to pay out guaranteed payments to each member that was equivalent to a reasonable salary for an attorney of that individual's experience level in their locality. The guaranteed payments were reported as self-employment income, and self-employment tax was paid on those amounts. To the extent the law firm had income in excess of the guaranteed payments, those amounts flowing out on the K-1s were treated as income not subject to self-employment tax.

The question of whether the members can escape self-employment tax depends on whether they should be treated as limited partners under IRC Section 1402(a)(13). IRC Section 1402(a) begins with a broad statement that partners are subject to self-employment tax on income flowing to them from a business carried on by the partnership. However, that is subject to several exclusions—the key one being at IRC Section 1402(a) (13), which exempts from treatment as self-employment income tax most income allocated to a limited partner, excluding only guaranteed payments received by the limited partner for services actually rendered.

As the Tax Court noted in its opinion, during the years in question (all of which are before 2011, the year the Renkemeyer decision was released), there was little guidance on how to handle the self-employment tax status of LLC members, especially if or to what extent and in what cases such members would qualify to be treated as limited partners under IRC Section 1402(a)(13). The Tax Court in Renkemeyer, while concluding the attorneys in that case did not qualify as limited partners, also made clear that federal tax limited partners would not just be limited to state law limited partners— and, presumably, that an LLC member could be a limited partner in circumstances other than those before the Tax Court in the Renkemeyer case.

So now, the issue becomes this: Is this fact pattern, which is clearly different from that of Renkemeyer, one where the members would be treated as limited partners with respect to the income other than the "reasonable compensation" guaranteed payments?

The court looked to the rationale in Renkemeyer, noting the following.

> Therefore, following the approach taken in Renkemeyer, our first inquiry is whether the person claiming the Section 1402(a)(13) exemption held a position in an entity treated as a partnership for Federal tax purposes that is functionally equivalent to that of a limited partner in a limited partnership. Mr. Castigliola, Mr. Banahan, and Mr. Mullen were all members of a member-managed PLLC. Consequently, the issue is whether a member of such a PLLC is functionally equivalent to a limited partner in a limited partnership.

The court then looked at the Uniform Limited Partnership Act, drafted in 1916, and the Revised Uniform Limited Partnership Act, issued in 1976, as well as the law adopted by Mississippi—the state in which the PLLC operated. The court found that all the sources defined a *limited partner* as having two key characteristics:

- Limited liability
- Lack of control of the business

As you might guess, the second test would prove problematical for the attorneys in the PLLC in question. The opinion notes the following.

> In this case, the respective interests in the PLLC held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen made each a member of the PLLC, which was member-managed. Therefore, management power over the business of the PLLC was vested in each of them through the interest each held. See id. Sec. 79-29-302 (effective after July 1, 1994). The PLLC had no written operating agreement, nor is there any evidence to show that any member's management power was limited in any way. Furthermore, all members participated in control of the PLLC: For example, they all participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. On the basis of the foregoing facts, the respective interests held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen could not have been limited partnership interests under any of the limited partnership acts. Therefore, they were not limited partners under Section 1402(a)(13).

As well, the court concluded that a limited partnership demands at least one general partner—but in this case, all the attorneys had the same responsibilities and rights.

The court noted the following.

> Because there must be at least one partner who is in control of the business, there must be at least one general partner. The members testified that all members participated equally in all decisions and had substantially identical relationships with the PLLC. There was no PLLC operating agreement or other evidence to suggest otherwise. But since by necessity at least one of the members must have occupied a role analogous to that of a general partner in a limited partnership, and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners in a limited partnership.

The court also cited the history of the firm—before becoming a PLLC, they had operated as a general partnership, and the court noted that they had not changed the way they managed the business when they formed the PLLC.

So, what does this case mean? Certainly, by the logic of the case, it appears that while it might not be impossible for a member-manager to be treated as a limited partner for some of his income, it certainly will be easier for someone who is not a manager. In fact, given the court's specific focus on the two-pronged definition, it seems that, in fact, a "mere member" may have a very strong argument that he must be treated as a limited partner. This view of limited management activity is consistent with the court's ruling in the Hardy v. Commissioner Case (T.C. Memo 2017-16).

The court applied a "could this person have been a state law limited partner?" test to the situation. Thus, it would be useful to consult with legal counsel regarding how provisions could be drafted to meet that test under the applicable state statute—what powers have been deemed under the state's law as "permissible" for a limited partner to have without losing his limited partner status.

Finally, it is important to note the court spent no time dealing with the fact that the guaranteed payments were truly a reasonable amount of compensation for the services provided by the member. While it is possible that this could be an issue with somewhat different facts, the court in this case admitted that the position taken was not an abusive position, refusing to impose penalties for these pre-Renkemeyer years. So, one key takeaway is that a member needs more than just a "reasonable compensation guaranteed payment" argument to sustain the position that some income is not subject to self-employment tax under this case's reasoning.

LLC Members Who Look Like Investors Avoid Self-Employment Treatment

A case that presented the reverse of the situation that the Tax Court decided in the 2011 case of *Renkemeyer, Campbell & Weaver, LLP v. Commissioner* on the issue of the self-employment tax liabilities of members of LLC was decided in the case of *Hardy v. Commissioner*, T.C. Memo 2017-16.

The case involved a surgeon that had purchased a 12½% interest in an LLC that operated a surgery center. The surgeon did not actively participate in the management or operation of the center, but only performed a minority of his surgeries in the center, on similar terms as he worked in centers and hospitals in which he had no ownership interest.

In general, IRC Section 1402 provides that a partner is subject to self-employment tax on the flow-through income from a trade or business conducted by the partnership—and clearly, in this case, the partnership was carrying on the business of operating the surgical center. But a special exception exists at IRC Section 1402(a)(13). The opinion notes the following.

> Section 1402(a) provides several exclusions from the general rule. In particular, Section 1402(a)(13) excludes "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services." The Commissioner argues that the Section 1402(a) (13) exclusion does not apply in this case. He argues that because Dr. Hardy performs surgeries at MBJ, he is not acting as a limited partner.

The Tax Court turns to the application of IRC Section 1402(a)(13) to members of an LLC. The court notes the following.

> The Code does not define "limited partner" for purposes of Section 1402(a)(13).
>
> However, we discussed the definition of limited partner in Renkemeyer, Campbell, & Weaver, LLP v. Commissioner, 136 T.C. 137 (2011). In that case, the partners were lawyers operating out of a law firm, which was formed as a limited liability partnership. The law firm received revenue from the partners' legal fees, but the firm did not report those revenues on the firm's tax return as net earnings from self-employment. The Commissioner determined that the partners' distributive shares of the law firm's net business income were subject to self-employment tax. We agreed. Because Section 1402(a)(13) was enacted before limited liability entities were contemplated and the term "limited partner" remained undefined, we interpreted

> the statute by looking at legislative history and explained that [t]he intent of Section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of Section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

In the *Renkemeyer* case, the court found that the members were subject to self-employment tax on their income from the partnership, using the partner's services to find that they could not qualify as limited partners for purposes of IRC Section 1402(a)(13).

But in this case, the court looked at the opposite possibility—that a member may be an investor who should qualify as a limited partner.

Dr. Hardy is an investor in MBJ, which is distinguishable from the limited liability partnership formed by the partners in the law firm in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*. MBJ owns and operates a surgical center. MBJ is equipped for doctors to perform surgeries that require local and general anesthesia. MBJ bills patients for the use of the facility. Although Dr. Hardy performs surgeries at MBJ, he is not involved in the operations of MBJ as a business. In contrast to the partners in *Renkemeyer, Campbell & Weaver, LLP*, who are lawyers practicing law and receiving distributive shares based on those fees from practicing law, Dr. Hardy is receiving a distribution based on the fees that patients pay to use the facility.

The patients separately pay Dr. Hardy his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital. Accordingly, Dr. Hardy's distributive shares are not subject to self-employment tax because he received the income in his capacity as an investor.

So now, advisers know that if a member is a service member with no investment, the member is not treated as a limited partner for Section 1402(a)(13) purposes. As well, if a member is an investor who performs no services related to operating the business but has made a significant investment of capital, we know the member is treated as a limited partner for Section 1402(a) (13) purposes.

What remains to be seen is the proper treatment of an LLC member who both performs significant services and has a significant amount of invested capital.

Passive Activity Classification

Another location in the IRC where the question arises of whether someone is a "limited partner" involves treatment of pass-through trade or business income from an LP interest generally as passive in nature, except as provided for in regulations (IRC Section 469(h)(2)).

If a taxpayer is found to be a limited partner, only three of the seven material participation tests are available to show material participation under Reg. Section 1.469-5T(a) (the 500-hour test, the materially participated in 5 of the preceding 10 tax years, or the activity is a personal service activity in which the taxpayer materially participated in any prior year).

Reg. Section 1.469-5T(e)(3) provides a two-pronged test for an LP interest. The first is simple— if the interest is an LP interest under state law, it will be treated as an LP interest (Reg. Section 1.469

5T(e)(3)(i)(A)). However, the regulation goes on to provide a second test that is applied to other interests.

Under that test, an individual is a limited partner if:

> [t]he liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership) (Reg. Section 1.469-5T(e)(3)(i)(B)).

Using that provision, the IRS had generally attempted to deny—as barred by the passive loss rules—losses flowing out to any member from an LLC or similar entity unless they could meet one of the three tests cited earlier.

However, the regulation goes on at Reg. Section 1.469-5T(e)(3)(ii) to tell us that if such an interest holder is also a general partner at all times during the year, then the holder will not be treated as a limited partner and all seven of the material participation tests would be available.

The Tax Court in the case of Garnett v. Commissioner, 132 T.C. 368 rejected the IRS view and found that if a taxpayer participated in the LLC or LLP, the taxpayer would be acting as a "general partner" given the justification Congress had for excluding LP interests from nonpassive treatment. Using somewhat different reasoning, the Court of Claims came to a similar conclusion in the 2009 case of Thompson v. United States, 2009 T.N.T. 138-4.

In an attempt to somewhat revise the findings in those and other cases, the IRS proposed regulations in REG-109369-10 that would modify Reg. Section 1.469-5.

Under the revised regulation, an individual shall be treated as holding an LP interest for purposes of the passive activity loss regulations only if the entity in question is classified for federal income tax purposes as a partnership under Reg. Section 301.7701-3 and the taxpayer does not have rights to manage the entity at all times during the tax year under the laws of the state where the organization is organized and under any governing agreement.

The regulations are issued at this point in proposed form only, so the case law from cases such as Garnett and Thompson should remain valid in making these determinations for LLC members. The fact that the regulations have remained in proposed status for a long time also suggests the IRS may be rethinking its position on this matter, though it has not withdrawn the proposal at the time this manual was written.

DETERMINATION OF INCOME OF THE PARTNERSHIP & THE PARTNERS

While the partnership is a reporting entity, it is not a taxpaying entity. The income, gains, losses, deductions, and credits are reported by the partnership and then the partners account for their distributive shares on their own returns. If the person entitled to the income is an assignee, then the assignee will have such items reported to it.

The partnership files a Form 1065 and reports its general operating income as a net number, along with the items that are to be separately reported by the partners. This accumulation is reported on Schedule K, with each partner's share on the partner's K-1.

Computation of Taxable Income

IRC Section 703(a) provides that the taxable income of a partnership shall be computed in the same manner as an individual except for the following:

- No personal exemptions
- No charitable deduction
- No NOL
- No deductions for Section 212 expenses related to the production of income, medical expenses related to the production of income, medical expenses, alimony payments, and itemized deductions under Part VII of Subchapter B
- No deductions for oil and gas depletion

These deductions are denied the partnership because they are taken by the partners on their own separate returns.

Overall Method of Accounting

Generally, a partnership is free to use any method of accounting allowed by law—cash, accrual, or hybrid. However, there are exceptions.

Partnerships with Corporate Partners

Any partnership with a C corporation as a partner is generally required to use the overall accrual method of accounting. However, there are exceptions that generally follow the exceptions available to C corporations themselves.

A C partner will not force the use of the accrual method by the partnership if:

- the partnership meets the $25 million gross receipts test, meaning that its average annual gross receipts do not exceed $25 million—average annual gross receipts are tested using the average annual gross for the past three years or, for a new partnership, since inception (annualizing the receipts for short periods). The partnership must change for the year following the year its average gross receipts exceed the allowable $25 million and it remains on the accrual basis thereafter, even if gross receipts drop below $25 million;
- the C corporation partner is a qualified personal service corporation; or
- the partnership is engaged in farming. (IRC Sections 448(b), (c))

EXAMPLE

C Corporation as a Partner

Moremoney, a cash-basis partnership, has a corporate partner, Jones Co. For its first 10 years of existence, its average annual gross receipts have been under $3 million. For 2008, its gross receipts were $2 million, for 2009 they were $6 million, and for 2010 they were $7.1 million.

Since the average for the past three years exceeds $5 million, the partnership must change to the accrual method for 2010 and remain on it for all future years, even if average gross receipts in future years do not exceed the $5 million threshold.

For years beginning before January 1, 2018, the $25 million limit on gross revenue was $5 million as in the above example. Partnerships that previously had been forced to the accrual basis due to having revenue in excess of $5 million, but do not have revenue in excess of $25 million, are eligible to request permission to change to the cash basis of accounting. At the time this manual was written, the IRS had not yet released the procedures to be used in that case.

Tax Shelters

An entity classified as a tax shelter must use the accrual method of accounting. There are three alternative tests for tax shelter status, only one of which is likely to pose a problem for most partnerships.

A tax shelter is a partnership that offers its interests for sale in an offering that is required to be registered with any state or federal agency with the authority to regulate security sales (Reg. Section 1.448-1T(b)(2)).

A tax shelter is any entity with the principal purpose of avoiding or evading federal income tax (Reg. Section 1.448-1T(b)(1)(iii)).

A tax shelter is a syndicate (on an annual basis, more than 35% of an entity's losses are allocated to limited partners or limited entrepreneurs as defined by Section 464(e)(2); (Reg. Section 1.448-1T(b)(3)).

For most operating partnerships, only the last category is the real exposure. A limited entrepreneur is an investor who does not actively participate in the management of an entity (IRC Section 1256(e)(3)(B); IRC Section 464(e)(4)).

If a partnership has no losses in a year, it can't be a syndicate since regulations use the term "allocated," rather than "allocable." For example, an LP is not a syndicate in a profit year (PLR 8911011). Note, though, that since a change in overall method of accounting requires IRS permission generally, a single loss year that creates a "syndicate" year would push the entity on the accrual basis. Moving back to the cash basis would require IRS approval and all such transitions (both to and from the cash basis) would require computation and application of the Section 481(a) adjustment.

The IRS has issued several private letter rulings on partnerships and the cash method of accounting—all favorable to the use of the cash method of accounting (i.e., PLR 9321047, PLR 9328005). The common elements of the letter ruling requests are as follows.

- The entities had no losses and expected no losses.
- All partners actively participated in the business, but not necessarily in the daily management of the partnership.
- All partners voted on critical issues.

Partnership Taxable Year

The partnership taxable year is critical to the partners as the partners report their share of the partnership items that flow through for the partnership tax year ending within or with that of the partner. With proper planning, this can allow a deferral of the recognition of income.

EXAMPLE

Determining Required Year-End

Maker's partnership has a taxable year ending on September 30. Ron and Patco, Inc. each own 50% interest in the partnership. Ron has a taxable year ending on December 31 and Patco has a June 30 year-end. Income for the year ending September 30, 2018, will be reported by Patco on its return for the year ended June 30, 2019. Income from October 1 to December 31, 2018, will not be reported by Ron until he files his 2019 return in April 2020 (assuming no extension).

Patco will pick up the income for the year ending in September 2018 on its 2018 tax return, which will be filed in September 2019.

General Explanation of Required Year-End Provisions (IRC Section 706)

Partnerships are not required to have a December year-end. The fact that many, perhaps most, of them do have a calendar year-end is a function of IRC Section 706, rather than the choice of the partners. IRC Section 706 restricts the partnership's choice of a tax year. The restriction is designed to eliminate as much income deferral as possible and is based on the partners' year-end. Thus, a partnership comprised solely of individuals with a calendar year-end must have a calendar year-end, unless it can convince the IRS that a different year makes sense— and that's not likely. If all else fails, the partnership can get a limited amount of deferral by using IRC Section 444 to elect a year-end, as discussed later.

A hierarchy of the year-end selection is as follows.

- First, the partnership must use the same tax year as one or more of the majority partners who, in aggregate, have an interest in the capital and profits that exceeds 50%. The partners must have used this common year for a period of three tax years or since inception, whichever is shorter. For example, if a partner owning 55% of the capital and profits of a partnership has a May 31 year-end, then the partnership will have a May 31 year-end.
- If the majority partners do not have a common year, the second option is to use the year of the principal partners. The principal partners are the partners having an interest in the capital or profits of 5% or more. This is the common year-end used or changed to by the partnership under this option.
- If the principal partners do not have the same tax year, the third choice is the least aggregate deferral method. This is the tax year that will allow for the least amount of income to be deferred by the partners, taking into consideration their respective ownership interests. This method requires an analysis of each of the potential tax years to determine the one that defers the least amount of income.

Impact of Foreign Partners

The regulations provide that foreign and tax-exempt partners that are not subject to U.S. taxation on a net basis are disregarded in determining the taxable year of a partnership. The foreign partner is considered subject to U.S. taxation on a net basis only if:

- the partner is allocated a share of income effectively connected to a U.S. trade or business in the immediately preceding year, or
- the partner is a controlled foreign corporation (CFC) or foreign personal holding company (FPHC) where the U.S. owners are subject to tax on a current basis on the earnings of the entity.
- A foreign partner will not be disregarded if the partnership's tax year would be determined by a reference to partners that individually hold interest in the partnership of less than 10 and in the aggregate, less than 20% or the capital and profits. The related party rules of Section 267 and 707(b) will apply substituting 10% for 50%.

The rule on foreign partners only applies to partnerships formed after September 22, 2002.

Least Aggregate Deferral

The least aggregate deferral method is described earlier, but it's easiest to understand by walking through an example of its application.

EXAMPLE

Least Aggregate Deferral Method

Basic partnership has three partners, each with a different tax year. Frank has a 40% interest and a year-end of December 31. Pipeco, Inc. has a 40% interest and a year-end of June 30.

Marvel, Inc. has a 20% interest and a year-end of September 30.

In applying the general rule, there is no majority partner tax year as no partners, individually or in aggregate, having a more than 50% interest in capital and profits have the same tax year. In applying test two, all partners are principal partners, each having a 5% or more interest in capital or profits. Since each has a different tax year and no partner is changing to a conforming year, that test cannot be applied. That leaves the third test—least aggregate deferral.

Test for 12/31

Partner	Interest	Tax Year	Deferral	Total
Frank	40%	12/31	0	0
Pipeco	40%	6/30	6	2.4
Marvel	20%	9/30	9	1.8
				4.2

Test for 6/30

Partner	Interest	Tax Year	Deferral	Total
Frank	40%	12/31	6	2.4
Pipeco	40%	6/30	0	0
Marvel	20%	9/30	3	0.6
				3.0

Test for 9/30

Frank	40%	12/31	3	1.2	
Pipeco	40%	6/30	9	3.6	
Marvel	20%	9/30	0	0.0	4.8

The required year is June 30 as it provides the least deferral in aggregate.

Business Purpose Year-End

A partnership may elect, with approval of the Service, a year-end for which it can establish a business purpose. Under this rule, the Service generally looks for a "peak season" year-end.

If the tests are met, a natural business cycle year-end may be established. Under this test, a taxpayer may change to a tax year if it can establish that 25% or more of its gross receipts are recognized in the last 2 months of the tax year and that such has occurred for the prior three consecutive 12-month periods ending on the proposed tax year-end. Thus, a new partnership cannot elect this but may change after meeting the three-year test.

IRC Section 444 Election

The final available year-end option is the Section 444 election. This election allows for a deferral of up to three months, even if its required year is less of a deferral. The partnership must pay a cost for this and that is a deposit with the government in a non-interest-bearing account of an amount that approximates the deferred income (less applicable payments— payments that will be picked up by partners under normal accounting rules such as interest and rent) multiplied by the highest individual rate plus 1% (IRC Section 7519). This election may not be made if the partnership is part of a tiered structure.

The election is made on Form 8716, which is filed by the earliest of the fifteenth day of the fifth month of the proposed tax year or the due date of the return for the year resulting from the Section 444 election. The deposit is made by filing Form 8752.

Procedures to Change Years

Reg. Section 1.442-1 provides the basis for permitting automatic tax year changes, as well as delegates authority to the IRS to provide administrative procedures to change tax years. The most recent procedures for partnerships to obtain automatic relief for tax year-end changes are found in Rev. Proc. 2006-46.

ELECTIONS

IRC Section 703(b) states that any election affecting the computation of income derived from the partnership shall be made by the partnership. The partnership will elect the following:

- Inventory methods
- Cost-recovery methods and assumptions (including bonus depreciation elections)
- Depletion methods (except oil and gas)

- Accounting methods
- Taxable year
- Amortization of organizational costs
- Amortization of start-up costs
- Optional adjustments to basis under Section 754
- Section 179 elections
- No recognition of involuntary conversion gains
- Election out of partnership rules
- Reporting out of installment treatments

Only the partner can make three elections separately under Section 703(b):

- The election relating to taxes of foreign countries and U.S. possessions
- The election relating to the deduction and recapture of certain mining exploration costs
- The election under Section 108 on reduction of basis

SECTION 199A QUALIFIED BUSINESS INCOME DEDUCTIONS & PARTNERSHIPS

The IRS issued certain final regulations under Section 199A in 2019 (T.D. 9847, 84 F.R. 2952-3014, 2/8/19; https://www.federalregister.gov/documents/2019/04/17/2019-07652/qualified-business-income-deduction-correction).

The regulations 1.199A-1 through 1.199A-6 are generally effective on February 8, 2019. However, for taxable years ending in 2018, taxpayer may rely on these regulations, in their entirety, or the set of proposed regulations issued on August 16, 2018, in their entirety, for years ending in 2018.

There are some new proposed regulations under Section 199A issued in 2019. The IRS issued proposed regulations concerning previously suspended losses that constitute qualified business income, as well as certain guidance relating to qualified investment companies, charitable remainder trusts and split-interest trusts (84 FR 3015-3023, 2/8/19, concerning amendments to Regs. 1.199A-3, https://www.federalregister.gov/documents/2019/02/08/2019-01023/qualified-business-income-deduction). It has also issued proposed regulations concerning Section 199A and cooperatives (84 FR 28668-28706, 6/19/19; https://www.federalregister.gov/documents/2019/06/19/2019-11501/section-199a-rules-for-cooperatives-and-their-patrons).

The regulations under IRC Section 199A contain special provisions related to partnerships so that the partners can properly calculate their Section 199A deduction. The Section 199A regulations refer partnerships and S corporations as *relevant pass-through entities* or RPEs.

RPEs (S corporations and partnerships) have computation and reporting requirements under the regulations. The regulations provide:

> An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their Section 199A deduction.[1]

RPE Computational Rules

The computational rules per the regulations are provided below:

> *Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their Section 199A deduction under Section 1.199A-1(c) or (d):*
>
> *(i) First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB under the rules of Section 1.199A-5. An SSTB is a specified service trade or business such as health, law, accounting, and other groups with less eligibility under Section 199A.*
>
> *(ii) Second, the RPE must apply the rules in Section 1.199A-3 to determine the QBI for each trade or business engaged in directly.*
>
> *(iii) Third, the RPE must apply the rules in Section 1.199A-2 to determine the W-2 wages and UBIA (unadjusted basis immediately before acquisition) of qualified property for each trade or business engaged in directly.*
>
> *(iv) Fourth, the RPE must determine whether it has any qualified REIT dividends as defined in 1.199A-3(c) (1) earned directly or through another RPE. The RPE must also determine the net amount of qualified PTP income as defined in Section 1.199A-3(c)(2) earned directly or indirectly through investments in PTPs.*[2]

RPE Reporting Rules

The regulations require the RPE provide information about trade or business directly engaged in by the RPE.

> *An RPE must separately identify and report on the Schedule K-1 issued to its owners for any trade or business engaged in directly by the RPE—*
>
> *(A) Each owner's allocable share of QBI, W-2 wages, and UBIA of qualified property attributable to each such trade or business, and*
>
> *(B) Whether any of the trades or businesses described in paragraph (b)(3)(i)(A) of this section is an SSTB.*[3]

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[1] Reg. Section 1.199A-6(b) (1)

[2] Reg. Section 1.199A-6(b)(2)

[3] Reg. Section 1.199A-6(b)(3)(i)

As well, the RPE must report the following other items under the regulations:

> An RPE must also report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends or qualified PTP income or loss received by the RPE (including through another RPE).[4]

Consequences If RPE Fails to Report Information

The regulations provide the following consequences for failure to report the required information to equity holders:

> If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any items described in paragraph (b)(3)(i) of this section, the owner's share (and the share of any upper-tier indirect owner) of positive QBI, W-2 wages, and UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.[5]

Qualified Business Income Computation Issues for a Partnership

The regulations under Section 199A also provide special rules to be used for computation of qualified business income (QBI) for a partnership.

Allocation of Unadjusted Basis Immediately After Acquisition (UBIA) of Qualified Property

A relevant pass-through entity (RPE) is required to allocate to each partner his/her share of UBIA of qualified property held by the partnership.

RPEs have to determine the amount of QBI to allocate to each equity holder. The allocation is described below as found initially in the proposed regulations, then as found in the final regulations:

> In the case of qualified property held by an RPE, each partner's or shareholder's share of the UBIA of qualified property is an amount which bears the same proportion to the total UBIA of qualified property as the partner's or shareholder's share of tax depreciation bears to the RPE's total tax depreciation with respect to the property for the year. In the case of qualified property held by a partnership which does not produce tax depreciation during the year (for example, property that has been held for less than 10 years but whose recovery period has ended), each partner's share of the UBIA of qualified property is based on how gain would be allocated to the partners pursuant to Sections 704(b) and 704(c) if the qualified property were sold in a hypothetical transaction for cash equal to the fair market value of the qualified property. This concept in the proposed regulations was modified in the final regulations. "The final regulations remove the reference to Section 704(c), stating that each partner's share of the UBIA of qualified property is determined in accordance with how depreciation would be allocated for Sec. 704(b)

[4] Reg. Section 1.199A-6(b)(3)(ii)

[5] Reg. Section 1.199A-6(b)(3)(iii)

> book purposes under Regs. 1.704-1(b)(2)(iv)(g) on the last day of the tax year." (Sally B. Schreiber, "Final regulations on Sec. 199A issued," The Tax Adviser, 4/1/19, American Institute of CPAs; https://www.thetaxadviser.com/issues/2019/apr/final-regulations-sec-199A-issued.html)
>
> In the case of qualified property held by an S corporation which does not produce tax depreciation during the year, each shareholder's share of the UBIA of qualified property is a share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total shares of the S corporation.[6]

Note that this may require the partnership to value any fully depreciated assets that have remaining Section 704(c) adjustments remaining at year end in order to properly allocate the UBIA of those assets.

Guaranteed Payment for Use of Capital

The amount reported to the partner on his/her Schedule K-1 as a guaranteed payment is not considered QBI. However, the partnership's deduction related to the payment is taken into account in computing QBI if the deduction is properly allocable to the trade or business and is deductible for Federal income tax purposes.[7]

As the preamble to the proposed regulations explained:

> Because guaranteed payments for the use of capital under Section 707(c) are determined without regard to the income of the partnership, proposed Section 1.199A-3(b)(1)(ii) provides that such payments are not considered attributable to a trade or business, and thus do not constitute QBI. However, the partnership's related expense for making the guaranteed payments may constitute QBI if the other requirements are satisfied.

Guaranteed Payments to Other Than Individuals

The preamble clarifies that the IRS does not limit the definition of a guaranteed payment to an individual, so that a guaranteed payment to a lower tier partnership would end up being excluded in computing QBI in the lower tier partnership. As the preamble noted:

> Section 199A(c)(4)(B) provides that QBI does not include any guaranteed payment described in Section 707(c) paid by a partnership to a partner for services rendered with respect to the trade or business. Proposed Section 1.199A-3(b)(2)(ii)(I) restates this statutory rule and clarifies that the partnership's deduction for such guaranteed payment is an item of QBI if it is properly allocable to the partnership's trade or business and is otherwise deductible for Federal income tax purposes. It may be unclear whether a guaranteed payment to an upper-tier partnership for services performed for a lower-tier partnership is QBI for the individual partners of the upper-tier partnership if the upper-tier partnership does not itself make a guaranteed payment to its partners. Section 199A(c)(4)(B) does not limit the term "partner" to

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[6] Reg. Section 1.199A-2(a)(3)

[7] Reg. Section 1.199A-2(b)(ii)

an individual. Consequently, for purposes of the guaranteed payment rule, a partner may be an RPE. Accordingly, proposed Section 1.199A-3(b)(2)(ii)(I) clarifies that QBI does not include any guaranteed payment described in Section 707(c) paid to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. Therefore, for the purposes of this rule, a guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient.

Section 707(a) to Partner in His/Her Capacity Other Than as a Partner

The IRS decided that even though Congress granted the agency clear latitude to allow some Section 707(a) payments as QBI, the agency decided to simply eliminate them all for now but requested comments on whether certain exceptions should exist. The preamble noted:

> Section 199A(c)(4)(C) provides that QBI does not include, to the extent provided in regulations, any payment described in Section 707(a) to a partner for services rendered with respect to the trade or business. Section 707(a) addresses arrangements in which a partner engages with the partnership other than in its capacity as a partner. Within the context of Section 199A, payments under Section 707(a) for services are similar to, and therefore, should be treated similarly as, guaranteed payments, reasonable compensation, and wages, none of which is includable in QBI. In addition, consistent with the tiered partnership rule for guaranteed payments described previously, to the extent an upper-tier RPE receives a Section 707(a) payment, that income should not constitute QBI to the partners of the upper-tier entity. Accordingly, proposed Section 1.199A-3(b)(2)(ii)(J) provides that QBI does not include any payment described in Section 707(a) to a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. The final regulations followed the proposed regulations in this regard.

PARTNERSHIPS & THE SECTION 167(J) SMALL BUSINESS EXCEPTION

A key provision in the Tax Cuts and Jobs Act of 2017 added a limitation on business interest deductions found at IRC Section 163(j). The limitation does not apply to any business, other than a tax shelter,[8] for a taxable year where the taxpayer meets the gross receipts test found in IRC Section 448(c) and the related regulations.[9]

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[8] As defined in IRC Section448(d)(3)

[9] Reg. Section1.163(j)-2(d)(1)

Gross Receipts Test

The gross receipts test found at Section 448(c) is generally met if the entity's average gross receipts for the preceding three taxable years does not exceed $25,000,000.[10] The $25,000,000 is adjusted annually for inflation.[11] For 2019, the $25,000,000 limit will be increased to $26,000,000.[12]

To qualify to use these special small business methods, a taxpayer must meet requirements outlined in IRC Section 448(c) and not be a tax shelter as defined in IRC Section 448(d)(2).

IRC Section 448(c) provides the following gross receipts test:

> (c) Gross receipts test
>
> For purposes of this section—
>
> (1) In general
>
> A corporation or partnership meets the gross receipts test of this subsection for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year that precedes such taxable year does not exceed $25,000,000.[13]
>
> (2) Aggregation rules
>
> All persons treated as a single employer under subsection (a) or (b) of Section 52 or subsection (m) or (o) of Section 414 shall be treated as one person for purposes of paragraph (1).
>
> (3) Special rules
>
> For purposes of this subsection—
>
> > (A) Not in existence for entire 3-year period
> >
> > If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.
> >
> > (B) Short taxable years
> >
> > Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

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[10] IRC Section448(c)(1)

[11] IRC Section448(c)(4)

[12] Revenue Procedure 2018-57

[13] For 2020 this is set at $26,000,000 under the inflation adjustment provided for at IRC Section448(c)(4) and published in Revenue Procedure 2019-44 noted earlier.

(C) Gross receipts

Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.

(D) Treatment of predecessors

Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.

(4) Adjustment for inflation

In the case of any taxable year beginning after December 31, 2018, the dollar amount in paragraph (1) shall be increased by an amount equal to—

(A) such dollar amount, multiplied by

(B) the cost-of-living adjustment determined under Section 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of $1,000,000, such amount shall be rounded to the nearest multiple of $1,000,000.

For purposes of applying the $25,000,000 test, aggregation rules under IRC Sections 52(a), (b), 414(m) and (o) are used to combine related entities.

Tax Shelters

But there is a key limitation involved here—the gross receipts exception does not apply to a tax shelter as defined at IRC Section 448(d)(3).

That definition reads:

> The term "tax shelter" has the meaning given such term by Section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in Section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.[14]

Tax shelters include the following under this definition:

- An enterprise, other than a C corporation, if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale;

[14] IRC Section448(d)(3)

- A tax shelter (which seems a circular definition, but this "tax shelter" is a subset of the larger Section 448(d)(3) tax shelter, this one defined at Section 6662(d)(2)(C), so we'll refer to this as a *Section 6662 tax shelter*); or

- A syndicate.[15]

Syndicates

The category that has traditionally been the most challenging has been the *syndicate* category. IRC Section 448 refers to the definition found at IRC Section 461(i)(3) which then references IRC Section 1256(e)(3)(B). However, the proposed regulation provides a generally self-contained definition that draws from those sections.

The basic definition of a *syndicate* is provided as follows by the proposed regulation:

> . . . [T]he term *syndicate* means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs.[16]

In the regulations the IRS has opted to continue to use the *allocated* test found in the prior Section 448 regulations even though Section 1256(e)(3)(B) itself uses the term *allocable*. Thus, if there is no loss generated for a tax year, the entity will not be a syndicate for that year. But if the entity has both profitable and unprofitable years, it may move in and out of syndicate status depending on the percentage of amounts allocated in loss years to equity holders qualifying as limited entrepreneurs or who are limited partners.

The regulation goes on to define the term *limited entrepreneur*, providing:

> . . . [T]he term *limited entrepreneur* has the same meaning given such term in Section 461(k)(4).

IRC Section 461(k)(4) has the actual definition, which provides that a *limited entrepreneur* is a person who:

- Has an interest in an enterprise other than as a limited partner, and

- Does not actively participate in the management of such enterprise.[17]

For purposes of the "active participation" test, IRC Section 1256(e)(3)(C) provides that an entity shall not be treated as held by a limited partner or limited entrepreneur:

- For any period if during such period such interest is held by an individual who actively participates at all times during such period in the management of such entity,

- For any period if during such period such interest is held by the spouse, children, grandchildren, and parents of an individual who actively participates at all times during such period in the management of such entity,

[15] Reg. Section1.448-2(b)(2)(i)
[16] Proposed Reg. Section1.448-2(b)(2)(iii)(A)
[17] IRC Section461(k)(4)

- If such interest is held by an individual who actively participated in the management of such entity for a period of not less than 5 years,

- If such interest is held by the estate of an individual who actively participated in the management of such entity or is held by the estate of an individual if with respect to such individual such interest was at any time described the second bullet, or

- If the IRS determines (by regulations or otherwise) that such interest should be treated as held by an individual who actively participates in the management of such entity, and that such entity and such interest are not used (or to be used) for tax-avoidance purposes.[18]

The 35% loss rule is tested without regard to the limitation on the deduction of business interest found in Section 163(j).[19] If this rule did not apply, the classification of a partnership as a syndicate when the interest was deducted could immediately throw the partnership into showing net income—which then would make it not a syndicate. But when the interest is deduction, the partnership is back to showing a loss, taking us back to step one in a perfect circle with no obvious means out.

While by default a taxpayer tests for tax shelter status by using the current year's return to see if 35% of losses have been allocated to limited partners or limited entrepreneurs, for purposes of the small business accounting method rules a taxpayer can elect to perform the test based on the prior year's activity:

> . . . [T]o determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation.[20]

Although the election was binding in future years under the proposed regulations, the IRS in the final regulations decided to revise that rule. As noted in the preamble to the final regulations:

> The Treasury Department and the IRS remain aware of the increased relevance of the definition of tax shelter under Section 448(d)(3) after enactment of the TCJA and the practical concerns regarding the determination of tax shelter status for the taxable year. To ameliorate these practical concerns, these final regulations modify the syndicate election provided in proposed Section 1.448-2(b)(2)(iii)(B) to provide additional relief by making the election an annual election. The Treasury Department and the IRS have determined that an annual election appropriately balances the statutory language with the consistency requirement for use of a method of accounting under Section 446(a) and Section 1.446-1. A cash method taxpayer that is generally profitable year-to-year may experience an unforeseen taxable loss for an anomalous year but return to its profitable position in subsequent years. If the taxpayer allocated more than 35 percent of the taxable loss to limited partners or limited entrepreneurs, the taxpayer would be required to change from the cash method to another method for the anomalous year in accordance with Section 448(a)(3). However, that taxpayer would otherwise not be prohibited under Section 448(a)(3) to use the cash method in the next profitable taxable year. An annual election under Section 1.448-2(b)(2)(iii)(B) allows a taxpayer to elect in the loss year to use the allocated taxable income or loss of the immediately preceding

[18] IRC Section1256(e)(3)(C)
[19] Reg. Section1.448-2(b)(2)(v)
[20] Reg. Section1.448-2(b)(2)(iii)(B)(1)

> taxable year to determine whether the taxpayer is a syndicate under Section 448(d)(3) for the current taxable year. The Treasury Department and the IRS have determined that permitting taxpayers to continue to use the cash method, as well as other methods impacted by a determination under Section 448(d)(3), in such situations is consistent with the requirements under Section 446(a).[21]

The regulations, therefore, in final form, provide the following:

> An election under this paragraph (b)(2)(iii)(B) applies only to the taxable year for which the election is made.[22]

The regulations provide the requirements and limitations for a taxpayer making this election:

> A taxpayer makes this election for the taxable year by attaching a statement to its timely filed original Federal income tax return (including extensions) for such taxable year. The statement must state that the taxpayer is making the election under Section 1.448-2(b)(2)(iii)(B). In the case of an S corporation or partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. An election under this paragraph (b)(2)(iii)(B) may not be made by the taxpayer in any other manner. For example, the election cannot be made through a request under Section 446(e) to change the taxpayer's method of accounting. A taxpayer may not revoke an election under this paragraph (b)(2)(iii)(B).[23]

The election to determine tax shelter status based on the prior year applies for *all* purposes under the IRC where it is relevant, not just these small business accounting methods. That would include taxpayers to whom the Section 163(j) business limitation rules would apply should they be treated as a tax shelter.

> Except as otherwise provided in guidance published in the Internal Revenue Bulletin (see Section 601.601(d)(2) of this chapter), a taxpayer that makes an election under this paragraph (b)(2)(iii)(B) must apply this election for other provisions of the Code that specifically apply the definition of tax shelter in Section 448(a)(3).[24]

The regulations provide the following examples of applying these rules:

REG. SECTION 1.448-2(B)(2)(III)(B), EXAMPLE 1

Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. For 2019, B is profitable and has no losses to allocate to its limited partner. For 2020, B is not profitable and allocates 60 percent of its losses to its general partner and 40 percent of its losses to its limited partner. For 2021, B is not profitable and allocates 50 percent of its losses to its general partner and 50 percent of its losses to its limited partner. For taxable year 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because B was profitable for 2019 and did not allocate any losses to its limited partner in 2019. For 2021, B is a syndicate because B allocated 50 percent of its 2021 losses to its limited partner under paragraph (b)(2)(ii)(3)(A) of this

[21] TD 9942, January 5, 2020, Summary of Comments and Explanation of Revisions, I. Overview, 2. Changes to Regulations under Section 448

[22] Reg. Section1.448.2(b)(2)(iii)(B)(1)

[23] Reg. Section1.448-2(b)(2)(iii)(B)(2)

[24] Reg. Section1.448-2(b)(2)(iii)(B)(1)

section. Even if B made an election under paragraph (b)(2)(iii)(B) of this section to use prior year allocated amounts, B is a syndicate for 2021 because B allocated 40 percent of its 2020 losses to its limited partner in 2020. Because B is a syndicate under paragraph (b)(2)(iii)(A) of this section for 2021, B is a tax shelter prohibited from using the cash method for taxable year 2021 under paragraph (b)(2)(i)(B) of this section.

REG. SECTION 1.448-2(B)(2)(III)(B), EXAMPLE 2

Same facts as Example (1) in paragraph (b)(2)(iii)(C)(1) of this section, except for 2021, B is profitable and has no losses to allocate to its limited partner. For 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because it did not any allocate any losses to its limited partner in 2019. For 2021, B chooses not to make the election under paragraph (b)(2)(iii)(B) of this section. For 2021, B is not a syndicate because it does not have any 2021 losses to allocate to a limited partner. For taxable years 2019, 2020 and 2021, B is not a syndicate under paragraph (b)(2)(iii)(A) of this section and is not prohibited from using the cash method for taxable years 2019, 2020 or 2021 under paragraph (b)(2)(i)(B) of this section.

As should be clear, many partnership structures can run afoul of the syndicate rules, especially those operating in real estate businesses with a number of passive investment partners and significant debt. While real estate operations do have an option to avoid the limit by becoming an electing real estate business, that election has other consequences and is permanent in nature.

Unit 2

Partnership Basics

LEARNING OBJECTIVES

- **Understand** the tax rules for forming a partnership.
- **Understand** the impact of liabilities on the formation of a partnership.
- **Determine** a partner's beginning basis in a partnership interest.
- **Compute** ongoing adjustments to a partner's basis in a partnership interest.
- **Understand** the effect of liabilities on a partner's basis.
- **Distinguish** recourse from nonrecourse liabilities.
- **Distinguish** inside basis from outside basis.
- **Recognize** the importance of a partner's basis.

It is very easy to form a partnership. It is equally easy to operate a partnership under normal conditions. The rules applicable to the formation and operation of a partnership are critical to the understanding of the general partnership tax law. A quick review of the rules will be helpful in understanding the complex issues discussed later in this material.

First, no legal documentation is required to form a general partnership. No state filing is required; although, for a limited partnership (LP) or a limited liability company (LLC), the state normally requires a filing similar to that required of a corporation. However, for a general partnership, no such formality exists. This flexibility is the biggest advantage, yet also the biggest problem, the partnership form of entity offers. Flexibility means that partners and partnerships can structure their arrangement any way they want. This, in turn, permits the tax benefits and burdens to flow in accordance with their agreement.

However, with flexibility comes the potential for abuse. The formation of a partnership offers a number of opportunities for gain shifting, income-recognition shifting, and basis shifting that Congress and the Treasury have tried to address with a variety of different rules. These limitations are designed to force the partners who contribute property or services to bear the burden of any tax liability arising from the ownership of the property or the provision of services. The partnership is limited in its ability to shift basis or deductions to the incoming partner or the existing partners.

Likewise, the partnership also operates under basis rules that govern the taxability of distributions and the gain or loss of disposition of all or a part of the partnership interest, as well as the ability of a partner to deduct partnership losses on the partner's tax return.

CONTRIBUTION OF PROPERTY

Recognition of Gain or Loss (IRC Section 721)

IRC Section 721(a) provides that "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." This nonrecognition provision applies both to partnership contributions of property at the time of partnership formation and to a partnership that is already formed and operating.

Unlike the nonrecognition provision of IRC Section 351 relating to contributions to corporations, IRC Section 721 does not require that the contributing partners be "in control" of the partnership immediately after the contribution. Thus, a partnership can admit a new partner contributing appreciated property for even a minor interest without triggering taxation to the new partner.

Despite the nonrecognition provision of IRC Section 721, gain must sometimes be recognized on the contribution of property to a partnership if the contributing partner is relieved of liabilities associated with the contributed property or if the partnership is an investment partnership. This exception to the nonrecognition rules is discussed shortly.

Partner's Initial Basis in Partnership Interest (IRC Section 722)

A partner's initial basis in a partnership interest is the total of:

- the amount of any cash contributed,
- the adjusted basis of any property contributed, and
- the amount of any gain recognized by the partner at the time of contribution (either in the case of a partnership, which would be an investment company, or when debt exceeds the basis of property contributed in exchange for a partnership interest).

EXAMPLE

Contribution of Property for a Partnership Interest

Fred contributes land to the Upscale Partnership in exchange for a partnership interest. At the time of the transfer, Fred's basis in the land was $50,000 and the debt on Fred's land was $60,000. Thus, the debt exceeded the land's basis by $10,000. Upscale assumed the debt, relieving Fred of any and all obligation on the debt. Since Fred will have $10,000 of gain on the transaction (the excess of the debt over the property's

basis), Fred's basis in his partnership interest is $60,000, the sum of his basis in the land ($50,000) and the excess of the debt over that basis recognized as income ($10,000).

Partnership's Basis in Contributed Property (IRC Section 723)

The adjusted basis of property in the hands of the contributing partner becomes the partnership's basis for that property.

Holding Period

If a partnership interest is acquired in exchange for property that is a capital (IRC Section 1221) asset or an IRC Section 1231 asset, the holding period of the partnership interest includes the partner's holding period for the property. For all other contributions, the partner's holding period begins on the date the partnership interest is acquired. Depreciable property held for less than one year and used in a trade or business is neither a capital asset nor an IRC Section 1231 asset. The holding period of a partnership interest acquired in exchange for such property begins on the date the partnership interest is acquired.

EXAMPLE

Holding Period for Contributed Property

Assume that Carol contributes equipment (an IRC Section 1231 asset) with a fair market value of $50,000 to the CB partnership for a one-third capital interest. Carol purchased the equipment two years ago for $100,000. Carol deducted depreciation of $37,000 over the last two years.

Carol's adjusted basis of $63,000 ($100,000 less $37,000) becomes the partnership's basis for the asset. The partnership's holding period includes the two years Carol held the property.

Carol's basis in her partnership interest is $63,000 and her holding period for the partnership interest includes the two years she held the equipment.

There is a trap here, though. See the following discussion of the recapture rules on property contributions.

Contribution of Notes

Contributions of notes to a partnership create different results depending on the type of note.

- Third-party note—the contribution of a third-party note is treated like any other contribution of property. Thus, there is no gain or loss on the contribution. If the note represents an installment sale, the contribution isn't treated as a disposition of the installment obligation unless the partnership is the maker of the note (Reg. Section 1.453-9(c)(2)).

- Subscription note—the contribution of a note to purchase the partnership interest is treated as a contribution of property, but the partner's basis in the note is zero and, thus, his basis in his partnership interest (if this is the only asset contributed) is also zero. As payments are made on the note, the partner's basis is increased accordingly.

- Partnership's own note—Reg. Section 1.721-1(d)(1) provides that, except as otherwise provided in Section 721 and regulations under that section, Section 721 applies to transfers of partnership

debt for a capital or profits interest in the partnership. Reg. Section 1.721-1(d)(2) provides, however, that Section 721 does not apply to a debt-for-equity exchange to the extent the transfer of interest is in exchange for unpaid rent, royalties, or interest accrued on or after the beginning of the creditor's holding period for the debt. So, the general nonrecognition treatment should be available for any transfer except those covering the proscribed three categories.

Character of Gain or Loss on Disposition of Certain Property

IRC Section 724 governs the character of gain or loss on unrealized receivables, inventory, and capital loss property contributed to the partnership. Gain or loss recognized by the partnership upon the disposition of contributed unrealized receivables retains its character as ordinary gain or loss.

Contributed inventory retains its character as ordinary gain or loss for the five-year period beginning on the date of contribution. Much like inventory, contributed capital loss property retains its character as a capital loss for a five-year period, but only to the extent of the loss at the time of contribution.

Issuance of Noncompensatory Options & Convertible Instruments

In Treasury Decision TD 9612 (www.gpo.gov/fdsys/pkg/FR-2013-02-05/pdf/201302259.pdf), the IRS issued final Reg. Sections 1.721-2 , 1.761-3, and amendments of Reg. Sections 1.171-1, 1.704-1, 1.704-3, 1.1272-1, 1.1273-2, and 1.1275-4 related to noncompensatory options and convertible instruments issued by a partnership.

The regulations provide that the nonrecognition rules of IRC Section 721 do not apply when a partnership issues a noncompensatory option for property or satisfies an obligation with a noncompensatory option (Reg. Section 1.721-2(b)). Generally, under Section 721, a partner transferring property to a partnership for an interest does not recognize gain or loss, so under these rules, the transfer will be a recognition event for the transferor. Under the open transaction doctrine generally applicable upon the issuance of an option, the partnership will not recognize income on the property transferred so long as the option is outstanding (TD 9612 Preamble, 1.A).

The nonrecognition rule of Section 721 does apply, however, to the contribution of property in exchange for convertible equity of the partnership (Reg. Section 1.721-2(b)(2)).

Generally, the nonrecognition rule of Section 721 does apply upon the exercise of a noncompensatory option that is satisfied with cash or property transferred to the partnership. (Reg. Section 1.721-2(a)(1)) However, the rule will not apply if the exercise price is satisfied with the partnership's obligation to the option holder for any of the following:

- Unpaid rent
- Unpaid royalties
- Unpaid interest (including original issue discount) (Reg. Section 1.721-2(a)(2))

In those cases, while the partner will recognize the income, the partnership will recognize neither gain nor loss on the transaction (Reg. Section 1.721-2(a)(2)).

The regulations describe the impact on the maintenance of capital accounts under Reg. Section 1.704-1 for the partnership with regard to transactions involving a noncompensatory option.

Reg. Section 1.704-1(b)(2)(iv) provides that the issuance of a noncompensatory option is a permissible revaluation event for the capital accounts.

Any revaluations undertaken while noncompensatory options are outstanding must take into account the fair market value (FMV) of the options. If the FMV of the options exceeds the consideration paid to the partnership to acquire the options, "the value of partnership property as reflected on the books of the partnership must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation" (Reg. Section 1.704-1(b)(2)(iv)(h)(2)).

If the reverse is true (consideration provided exceeds the fair value of the options), "then the value of partnership property as reflected on the books of the partnership must be increased by that excess to the extent of the unrealized loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized loss in proportion to their respective amounts of unrealized loss" (Reg. Section 1.704-1(b)(2)(iv)(h)(2)).

The adjustments in either case must take into account the economic arrangements of the partners with respect to the property (Reg. Section 1.704-1(b)(2)(iv)(h)(2)).

Upon exercise of a noncompensatory option, the capital account regulations require the partnership to revalue its property (Reg. Section 1.704-1(b)(2)(iv)(s)). The option holder's capital account is credited with the cost of the option plus the FMV of any property contributed to satisfy the exercise price. The partnership first adjusts the option holder's capital account to reflect the holder's right to partnership capital, and then to the pre-exercise partners to reflect the allocation of items if an immediate liquidation were to take place following the exercise.

Reg. Section 1.704-1(b)(2)(iv)(s)(2) provides:

> if the exercising partner's initial capital account as determined under Sections 1.704-1(b) (2)(iv)(b) and (d)(4) of this section would be less than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation. If the exercising partner's initial capital account, as determined under Sections 1.704- 1(b)(2)(iv)(b) and (d)(4) of this section, would be greater than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only loss may be allocated to the exercising partner from partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss. However, any allocation must take into account the economic arrangement of the partners with respect to the property.

The partnership is required to make corrective allocations to take into account the capital account reallocation upon exercise (Reg. Section 1.704-1(b)(2)(iv)(x)). Specifically, the regulation provides:

> [i]f an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross

loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross income and gain as to further take into account the capital account reallocation.

The regulations take into account the fact that in certain situations, the rights of an option holder may be so close to the rights of a partner that the option holder will be treated as a partner (Reg. Section 1.761-3). The holder is tested on the occurrence of a *measurement event*, which is one of the following:

- Issuance of the noncompensatory option
- An adjustment of the terms (modification) of the noncompensatory option or of the underlying partnership interest (including an adjustment pursuant to the terms of the noncompensatory option or the underlying partnership interest)
- Transfer of the noncompensatory option if either:
  - the option may be exercised (or settled) more than 12 months after its issuance, or
  - the transfer is pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate federal tax liabilities of the partners and the noncompensatory option holder (Reg. Section 1.761-3(c)(1))

Certain events, however, are excluded from the category of "measurement events," and these include:

- a transfer of the noncompensatory option at death, between spouses or
- former spouses under IRC Section 1041, or in a transaction that is disregarded for federal tax purposes;
- a modification that neither materially increases the likelihood that the noncompensatory option will be exercised nor provides the noncompensatory option holder with a partner;
- a change in the strike price of a noncompensatory option or in the interests in the issuing partnership that may be issued or transferred pursuant to the noncompensatory option, made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the noncompensatory option holder; or
- any other event as provided in guidance published in the Internal Revenue Bulletin (Reg. Section 1.761- 3(c)(2)).

An option holder will be treated as holding a partnership interest if, at the measurement event:

- the noncompensatory option (and any agreements associated with it) provides the option holder with rights that are substantially similar to the rights afforded a partner; and

- there is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partner's and noncompensatory option holder's aggregate federal tax liabilities (Reg. Section 1.761-3(a)).

Rights are considered "substantially similar" to the rights afforded a partner normally under a facts and circumstances test (Reg. Section 1.761-3(d)(3)). However, the regulations provide that certain rights conclusively establish the option holder as having partner attributes.

These rights are:

- the option holder is provided with rights (through the option agreement or a related agreement) that are similar to rights ordinarily afforded to a partner to participate in partnership profits through present possessory rights to share in current operating or liquidating distributions with respect to the underlying partnership interests; or

- the option holder, directly or indirectly, undertakes obligations (through the option agreement or a related agreement) that are similar to obligations undertaken by a partner to bear partnership losses (Reg. Section 1.761-3(d)(3)(ii)).

The "reasonable certainty of exercise" is established on the facts and circumstances. The regulation provides the following list of items to be considered:

- The FMV of the partnership interest that is the subject of the noncompensatory option

- The strike price of the noncompensatory option

- The term of the noncompensatory option

- The volatility of the value or income of the issuing partnership or the underlying partnership interest

- Anticipated distributions by the partnership during the term of the noncompensatory option

- Any other special option features, such as a strike price that fluctuates

- The existence of related options, including reciprocal options

- Any other arrangements affecting or undertaken with a principal purpose of affecting the likelihood that the noncompensatory option will be exercised

Regulation Section 1.171-1 is modified to indicate that, for purposes of the treatment of bond premiums, debt that is convertible into a partnership interest is covered by the regulation, and the partnership interest will be treated as stock for the purposes of convertible debt instruments (Reg. Section 1.171-1(e)(1)(iii)(C)).

EFFECTS OF LIABILITIES IN CONNECTION WITH PROPERTY CONTRIBUTION

The treatment of property contributions to a partnership becomes more complex when liabilities are present. Where a partnership is concerned, debts are often treated as a cash substitute. When a partner is allocated additional debt, the treatment is as if a partner put cash into the partnership.

Similarly, when a partner's share of debt allocation is reduced, that is treated like a cash distribution.

When a partnership assumes a liability of the contributing partner or takes contributed property subject to a liability, IRC Section 752(b) provides that the decrease in the contributing partner's liability is treated as a cash distribution to the contributing partner. This deemed cash distribution decreases the contributing partner's basis in the partnership interest, but not below zero. Under IRC Section 752(a), an increase in a partner's share of the liabilities of a partnership is treated as a cash contribution by the partner to the partnership.

Under Rev. Rul. 79-205, the decrease in a contributing partner's individual liabilities and the increase in the partner's share of partnership liabilities are viewed as simultaneous transactions. When offset, the contributing partner's basis in the partnership interest is decreased by the net amount of liabilities allocated to other partners as a result of the partnership's assumption of his liabilities. If the deemed distribution resulting from the partnership's assumption of the partner's liabilities, net of the partner's deemed contribution resulting from his share of partnership liabilities assumed, exceeds the partner's basis in the contributed property, the excess is taxable gain (IRC Sections 752(b) and 731(a)).

This is demonstrated in the following example:

EXAMPLE

Assumption of Liabilities by Partnership

Assume that Glenda, a one-third partner in the Davis partnership, transfers property with a basis in her hands of $100,000 to a partnership subject to a liability of $60,000.

Under IRC Section 752(b), Glenda is considered to have received a cash distribution of $60,000. Since she is a one-third partner, her share of the increase in partnership liabilities is $20,000 ($60,000 × 1/3). Under IRC Section 752(a), she is considered to have made a cash contribution to the partnership for this amount. These events are deemed to occur simultaneously.

Accordingly, these transactions offset one another and Glenda is deemed to have received a net cash distribution of $40,000 ($60,000 distribution less $20,000 contribution). In effect, Glenda's basis in her partnership interest is decreased by the amount of her liabilities allocated to the other partners ($60,000 × 2/3 = $40,000). The effect on her basis in her partnership interest is $100,000 – $60,000 + $20,000 = $60,000.

These rules, when combined with the contribution rules previously discussed, can be summarized as follows:

- The contributing partner's basis in his partnership interest is increased by the amount of cash contributed plus his adjusted basis in any property contributed.
- The contributing partner's basis in his partnership interest is decreased, but not below zero, by the amount of his individual liabilities assumed by the partnership.
- The contributing partner's basis is increased by his share of the increase in partnership liabilities resulting from the assumption.
- If the net decrease in the contributing partner's individual liabilities exceeds his basis in the partnership interest, the excess is taxable as gain. The gain is capital gain unless IRC Section 751 applies.

- The basis of each noncontributing partner's interest in the partnership is increased by a prorate share of the partnership liabilities resulting from the assumption.

The partnership's basis in the contributed property is generally not affected by the gain realized by the contributing partner. This ignores the possibility of an IRC Section 754 election to adjust the basis of partnership property under IRC Section 734(b).

Application of the rules to the contribution of property subject to a liability is illustrated in the following examples.

EXAMPLE

Basis of Contributed Property Exceeds Liability

Assume that Keith contributes land to a partnership in exchange for a 20% interest in the partnership. The land has an FMV of $10,000 at the time of contribution, an adjusted basis to Keith of $4,000, and is subject to a mortgage of $2,000. The land is a long-term capital asset in Keith's hands.

Since the adjusted basis of Keith's property is greater than the liability assumed by the partnership, the transfer of the liability to the partnership does not cause Keith to recognize gain on the contribution. The assumption of the liability by the partnership does affect Keith's basis in his partnership interest.

The basis of Keith's partnership interest is computed as follows:

Basis Capital Account

	Basis	Capital Account
Keith's adjusted basis in contributed property	$4,000	$10,000
Plus: Increase in Keith's share of partnership liabilities ($2,000 x 20%)	$400	0
Less: Decrease in Keith's individual liabilities resulting from assumption of mortgage by partnership	–$2,000	–$2,000
Adjusted basis of Keith's partnership interest $2,400	$2,400	$8,000

The partnership's basis in the land contributed is $4,000, the adjusted basis of the land in Keith's hands. The other partners' bases in their partnership interest are increased by their share of the $2,000 mortgage or $1,600.

EXAMPLE

Liability Exceeds Basis of Contributed Property

Assume that Walt contributes land to a partnership in exchange for a 20% interest in the partnership. At the time of contribution, the land has an FMV of $10,000, an adjusted basis to Walt of $4,000, and is subject to a mortgage of $6,000. The land is a long-term capital asset in Walt's hands.

Under these facts, the basis of Walt's partnership interest is computed as follows:

	Basis	Capital Account
Adjusted basis to Walt of contributed property	$4,000	$10,000
Plus: Increase in Walt's share of partnership liabilities ($6,000 x 20%)	$1,200	0
Less: Decrease in Walt's individual liabilities resulting from assumption of mortgage by partnership	–$6,000	–$6,000
Tentative basis of Walt's partnership interest	–$800	$4,000

Under IRC Section 733, a partner's basis in his partnership interest cannot be less than zero. IRC Section 731(a) states that gain is recognized by a partner to the extent a distribution to him exceeds the adjusted basis of his partnership interest. In this example, the basis of Walt's partnership interest is zero and he must recognize gain of $800 on the contribution.

This gain is treated as a gain from the sale or exchange of Walt's partnership interest, not as a gain from the sale or exchange of the land. Under IRC Section 741, gain from the sale or exchange of a partnership interest is capital gain unless the partnership owns "ordinary income" assets taxable under Section 751. Since Walt's holding period of his partnership interest includes his holding period for the contributed land, Walt's recognized gain is long-term capital gain.

Absent an election under IRC Section 754, the partnership's basis in the contributed land is not affected by Walt's recognized gain. The partnership has an adjusted basis in the land of $4,000. The other partners' bases in their partnership interests are increased by their share of the $6,000 liability assumed by the partnership.

The contribution of property subject to liabilities in excess of its basis does not automatically trigger the recognition of gain equal to the excess liabilities. Walt recognized gain in this example because his deemed distribution resulting from the decrease in his individual liabilities exceeded his basis for his partnership interest. Walt's recognized gain results not because the liability assumed by the partnership exceeds his basis in the contributed property. If Walt's basis in the property had been $4,800 or more, he would not have recognized gain even though the liability of $6,000 exceeded his basis. He also would not have recognized gain if he had been a one-half partner so that his share of the increased partnership liabilities was $3,000 instead of $1,200. Nor would he recognize gain if his share of other partnership liabilities was at least $800.

The best method of determining if gain must be recognized by the contributing partner is to compare the net amount of liabilities from which the contributing partner is relieved to the adjusted basis of his partnership interest at the time of contribution.

To the extent the partner is relieved of liabilities in excess of the basis of his partnership interest, he must recognize gain. Under the "pretend its cash" treatment, the partner is treated as having received cash due to the relief from debt.

The following example illustrates another transaction in which property is contributed to a partnership subject to liabilities in excess of the contributed property's basis. In this example, no gain is recognized by the contributing partner since the decrease in the contributing partner's liabilities does not exceed the basis of her partnership interest.

EXAMPLE

Liabilities Exceeds Basis of Contributed Property

Assume that Valerie contributes land to a partnership in exchange for a 20% interest in the partnership. At the time of contribution, the land has an FMV of $10,000, an adjusted basis to Valerie of $4,000, and is subject to a mortgage of $6,000. At the time of Valerie's admission to the partnership, the partnership had $4,000 of other liabilities.

In this example, the basis of Valerie's partnership interest is computed as follows:

Adjusted basis to Valerie of property contributed	$4,000
Plus: Valerie's share of other partnership liabilities ($4,000 x 20%)	$800
Plus: Increase in Valerie's share of partnership liabilities from partnership's assumption of mortgage ($6,000 x 20%)	$1,200
Less: Decrease in Valerie's individual liabilities from partnership's assumption of mortgage	($6,000)
Adjusted basis of Valerie's partnership interest	$0

Since the decrease of Valerie's individual liabilities does not exceed her basis in the contributed property plus her share of partnership liabilities, Valerie recognizes no gain on the contribution of the land to the partnership.

RECAPTURE PROVISIONS

The contribution of depreciated property to a partnership in exchange for a partnership interest does not trigger IRC Section 1245 or IRC Section 1250 recapture to the contributing partner unless the partner recognizes gain under IRC Section 721(a) as a result of the contribution.

EXAMPLE

Contribution of Recapture Property

Assume that Ed contributes IRC Section 1245 property with an FMV of $10,000 to a partnership for a 50% partnership interest. The property was purchased for $8,000 and depreciation of $3,000 was deducted in prior years. The property in Ed's hands has an adjusted basis of $5,000 and is subject to a potential depreciation recapture of $3,000.

Since Ed recognizes no gain under IRC Section 721(a) as a result of the contribution, no IRC Section 1245 recapture is recognized.

The partner's basis of contributed recapture property becomes the partnership's basis for the property. The potential recapture of depreciation also carries over to the partnership. In the event that the partnership later sells or transfers the property, the partnership may be required to recapture depreciation taken by the contributing partner prior to the contribution of the property to the partnership. Under IRC Section 704(c), this gain is allocated to the partner contributing the property.

Warning: The carryover of any depreciation recapture means that the proper basis and accumulated depreciation records must be maintained both before and after the property transfer.

If the contributing partner recognizes gain under IRC Section 721(a) on the contribution of depreciated property, the depreciation recapture rules of IRC Section 1245 and

IRC Section 1250 apply. The amount of depreciation recaptured is the lesser of the amount of the gain recognized under IRC Section 721(a), or the amount of depreciation recapture that would have been recognized had the property been sold for its FMV (IRC Sections 1245(b)(3) and 1250(d)(3) and Reg. Sections 1.1245-4(c) and 1.1250-3(c)).

EXAMPLE

Recapture of Depreciation

Assume that Hal contributes depreciated property with an FMV of $19,000 to a partnership in exchange for a 50% partnership interest. The property was purchased for $20,000, and depreciation of $16,000 was deducted in prior years. The adjusted basis of the property in A's hands is $4,000. The property is contributed subject to a liability of $10,000.

Under IRC Section 721(a), Hal recognizes $1,000 gain on the contribution, computed as follows:

Hal's adjusted basis of contributed property	$4,000
Plus: Hal's share of partnership liabilities ($10,000 x 50%)	$5,000
Less: Decrease in Hal's individual liabilities	–$10,000
Gain required to be recognized	$1,000

If Hal had sold the property for its FMV of $19,000, he would have recognized depreciation recapture of $15,000 ($19,000 value less $4,000 basis). Since the gain Hal recognizes under IRC

Section 721(a) of $1,000 is less than the $15,000 of recapture he would have recognized in a sale of the property, the entire $1,000 gain is treated as ordinary income recapture.

Depreciation recapture rules apply only when the contributing partner recognizes gain under IRC Section 721(a).

IRS PARTNERSHIP TAX BASIS CAPITAL ACCOUNT REPORTING REQUIREMENTS

The IRS in 2020 moved to require partnerships to report partners' capital on Form 1065 on the tax basis.[25] The IRS issued a news release on the matter at the time the draft 2020 instructions were released in October 2020.[26]

[25] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, https://www.irs.gov/pub/irs-pdf/i1065.pdf (retrieved June 21, 2021)

[26] IR-2020-240, October 22, 2020, https://www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting (retrieved October 22, 202)

News Release Summary

The news release indicates that the IRS has decided to require partnerships to use the transactional approach in computing partners' capital on the tax basis, and require tax basis capital reporting on the 2020 Schedules K-1, Form 1065. The release states:

> The revised instructions indicate that partnerships filing Form 1065 for tax year 2020 are to calculate partner capital accounts using the transactional approach for the tax basis method. Under the tax basis method outlined in the instructions, partnerships report partner contributions, the partner's share of partnership net income or loss, withdrawals and distributions, and other increases or decreases using tax basis principles as opposed to reporting using other methods such as GAAP.
>
> According to IRS data, most partnerships already use the tax basis method although partnerships previously could report capital accounts determined under multiple methods.[27]

This means that partnerships that have always reported on the tax basis for partners' capital (which is what the IRS refers to as the transactional approach) will not need to use one of the methods proposed in Notice 2020-43 to determine partners' capital, either initially or on a continuing basis. That notice had proposed barring the use of the transactional approach[28] due to inconsistent use, but many commenters complained about the requirement to force partnerships that had always been reporting on something they felt was tax basis to go through one of the two alternative methods proposed in the Notice.

In the end, it appears the IRS not only relented and will allow continued use of the transactional approach, but has decided that is the only method to be allowed to be used following the computation of beginning partners tax basis capital for 2020 Schedules K-1.

The IRS defined the transactional approach as follows in Notice 2020-43:

> Commenters have indicated that many partnerships that currently possess partner tax capital information generally develop and maintain partner tax capital by applying the provisions and principles of subchapter K of chapter 1 of the Code (subchapter K), including those contained in Sections 705, 722, 733, and 742 of the Code, to relevant partnership and partner events. In such a situation, commenters have indicated that partnerships maintaining tax capital (i) increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and (ii) decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner (Transactional Approach).[29]

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[27] IR-2020-240, October 22, 2020

[28] Notice 2020-43, Section III (retrieved October 22, 2020)

[29] Notice 2020-43, Section III (retrieved October 22, 2020)

The IRS will reserve the two methods discussed in Notice 2020-43 solely for partnerships that have not been reporting partners' capital on the tax basis. They can use these methods, among others, to compute their partners' beginning tax basis capital.

> Partnerships that did not prepare Schedules K-1 under the tax capital method for 2019 or otherwise maintain tax basis capital accounts in their books and records (for example, for purposes of reporting negative capital accounts) may determine each partner's beginning tax basis capital account balance for 2020 using one of the following methods: the Modified Outside Basis Method, the Modified Previously Taxed Capital Method, or the Section 704(b) Method, as described in the instructions, including special rules for publicly traded partnerships.[30]

The news release also indicates the IRS plans to publish a notice granting penalty relief for partnerships in this year of transition to tax basis capital account reporting:

> To promote compliance with using the tax basis method described in the revised instructions, the Treasury Department and the IRS intend to issue a notice providing additional penalty relief for the transition in tax year 2020. The notice will provide that solely for tax year 2020 (for partnership returns due in 2021), the IRS will not assess a partnership a penalty for any errors in reporting its partners' beginning capital account balances on Schedules K-1 if the partnership takes ordinary and prudent business care in following the form instructions to calculate and report the beginning capital account balances. This penalty relief will be in addition to the reasonable cause exception to penalties for any incorrect reporting of a beginning capital account balance.[31]

Likely the IRS has decided that the objections to date have primarily been related to the conversion of a minority of existing partnerships to the tax basis capital account reporting rather than the use of it on a continuing basis. So, the agency has decided to be lenient in what will be allowed to compute the converted beginning tax basis capital account for partners, but then be strict regarding changes to those accounts being made only on the tax basis.

Instructions for Tax Basis Capital Accounts

The instructions begin by reminding taxpayers that the use of the tax basis is mandatory for 2020 partnership tax returns:

> **Tax basis method.** Figure each partner's capital account for the partnership's tax year using the transactional approach, discussed below, for the tax basis method. If you reported the partner's capital account last year using any other method (for example, GAAP, Section 704(b), or other), you must use the tax basis method this year.[32]

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[30] IR-2020-240, October 22, 2020

[31] IR-2020-240, October 22, 2020

[32] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31

Basic Transactional Method Approach

The IRS begins by describing a standard rule taxpayers should use to report partnership events or transactions:

> If you are uncertain how to report a partnership event or transaction, you should account for the event or transaction in a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of Sections 705, 722, 733, and 742 and by reporting the amount on the line for other increase (decrease). *The partner's ending capital account as reported using the tax basis method in item L might not equal the partner's adjusted tax basis in its partnership interest.* (emphasis added) Generally, this is because a partner's adjusted tax basis in its partnership interest includes the partner's share of partnership liabilities, as well as partner specific adjustments. Each partner is responsible for maintaining a record of the adjusted tax basis in its partnership interest.[33]

Beginning Capital Account for Partnerships Previously Reporting on the Tax Basis

The IRS gives some information first for the majority of partnerships already purporting to report partners' capital on the tax basis about the beginning capital account reporting for 2020. The IRS starts by noting that taxpayers should, in this case, report the beginning capital account as the same number reported as the ending capital account on the prior year's Form 1065:

> If you figured the partner's capital account for last year using the tax basis method, enter the partner's ending capital account as determined for last year on the line for beginning capital account.[34]

Some taxpayers, now understanding that the IRS is looking to focus on negative capital accounts, may decide to recalculate their tax basis capital accounts. The IRS indicates that if they do so, some additional information will be necessary for partners whose capital account was negative on the prior return, but now shows a positive beginning balance:

> If you reported a negative ending capital account to a partner last year and a different amount is figured for the partner's beginning capital account using the tax basis method this year, provide an explanation for the difference.[35]

As well, the IRS provides guidance for dealing with partners who did not hold a partnership interest in the prior year:

> If a partner joined the partnership through a contribution to the partnership this year, enter zero as the partner's beginning capital account.[36]

[33] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31
[34] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31
[35] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31
[36] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31

Contributions of Capital

The IRS gives the following instructions for properly reporting contributions of capital for tax basis capital account reporting:

> On the line for capital contributed during the year, enter the amount of cash plus the adjusted tax basis of all property contributed by the partner to the partnership during the year. The amount you enter on this line should be reduced by any liabilities assumed by the partnership in connection with, or liabilities to which the property is subject immediately before, the contribution. This amount might be negative.[37]

Note that final sentence—if a taxpayer's capital contribution included liabilities in excess of the basis of the property contributed, the capital contribution *should be a negative number*.

Current Year Net Income (Loss)

The income or loss line should be filled in as follows per the instructions:

> On the line for current year net income (loss), enter the partner's distributive share of partnership income and gain (including tax-exempt income) as figured for tax purposes for the year, minus the partner's distributive share of partnership loss and deductions (including nondeductible, noncapital expenditures) as figured for tax purposes for the year.[38]

Other Increases (Decreases)

The IRS goes on to describe the items that would be found in the other increases (decreases) box, with certain specific examples:

> On the line for other increase (decrease), enter the sum of all other increases or decreases that affected the partner's capital account for tax purposes during the year and attach a statement explaining each adjustment. For example, include increases for the following.
>
> - The partner's distributive share of the excess of the tax deductions for depletion (other than oil and gas depletion) over the adjusted tax basis of the property subject to depletion.
> - The partner's share of any increase to the adjusted tax basis of partnership property under Section 734(b).
>
> If a transferor partner disposed of its interest in the partnership by sale, exchange, gift, or as the result of death, enter the transferor partner's ending capital account

[37] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31

[38] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31

with respect to the interest transferred immediately before the transfer figured using the tax basis method. Other examples of decreases include the following.

- The partner's distributive share of tax deductions for depletion of any partnership oil and gas property, but not exceeding the partner's share of the adjusted tax basis of that property.

- The partner's share of any decreases to the adjusted tax basis of partnership property under Section 734(b).[39]

While Section 734 adjustments do affect partners tax basis capital accounts under the IRS system, the other adjustment triggered by an election under Section 754 does *not* affect partners tax basis capital accounts. Section 734 adjustments are internal to the partnership and affect all partners, while the Section 743 adjustment only affects the partner acquiring an interest. The IRS not only warns about this, but requires partnerships that have recorded a Section 743 adjustment in a manner that causes it to be included in a partner's purported tax basis capital account to remove that net adjustment on the 2020 return:

> **Note**: Section 743(b) basis adjustments are not taken into account in calculating a partner's capital account under the tax basis method. If Section 743(b) adjustments are included in a partner's beginning capital account balance (because they were included in last year's ending capital account), those Section 743(b) adjustments, whether positive or negative adjustments, should be removed from the partner's capital account in the 2020 tax year and reported as a 2020 tax year other increase(decrease) item.[40]

Withdrawals & Distributions

The box that contains withdrawals and distributions should be computed for tax basis capital accounts as follows per the IRS instructions:

> On the line for withdrawals and distributions, enter the amount of cash plus the adjusted tax basis of all property distributed by the partnership to the partner during the year. The amount you enter on this line should be reduced by any liabilities assumed by the partner in connection with, or liabilities to which the property is subject immediately before, the distribution. This amount might be negative.[41]

Note that, as was true for capital contributions, distributions with liabilities in excess of basis may cause this number to properly be negative.

Ending Capital Account

Finally, the instructions discuss the ending capital account on the tax basis—and, not surprisingly, the IRS insists the column must add down to come up with the ending capital line:

> The sum of the amounts shown on the lines in item L above the line for ending capital account must equal the amount reported on the line for ending capital

[39] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, pp. 31-32
[40] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, pp. 32
[41] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, pp. 32

> account. A partner's ending capital account determined under the tax basis method may be negative if the sum of a partner's losses and distributions exceeds the sum of the partner's contributions and share of income.[42]

Reconciliation with Schedule L (Balance Sheet) Partners' Capital Accounts

So, must the capital accounts on the Schedule K-1s in total agree with the partners' capital accounts reported on Schedule L (Balance Sheet)? The answer is no, but only if Schedule L is not prepared on the tax basis.

The instructions to Schedule M-2 indicate that the reconciliation of partners' capital accounts is always prepared on the tax basis.[43]

> Show what caused the changes during the tax year in the partners' capital accounts as reflected on the partnership's books and records used in figuring the partnership's net income or loss for tax purposes, the amount of any contributions and distributions of money or property made by the partnership to its partners, and any other increases or decreases to the partners' capital accounts determined in a manner generally consistent with calculating the partners' adjusted tax bases in their partnership interests (without regard to partnership liabilities), taking into account the rules and principles of Sections 705, 722, 733, and 742.[44]

But the instructions note that while you must reconcile Schedule L capital to the totals on partner's K-1 capital account balances if the Schedule L balance sheet is presented on the tax basis, the reconciliation is not required if the Schedule L balance sheet is not reported on the tax basis:

> The balance at the beginning of the year should equal the total of the amounts reported as the partners' beginning tax basis capital accounts in item L of all the partners' Schedules K-1. If not, the partnership should attach an explanation of the difference. Generally, the balance at the beginning of the year should equal the adjusted tax basis of the partnership's assets at the beginning of the year reduced by the partnership's liabilities at the beginning of the year. If the partnership's balance sheet (Schedule L) is reported on the tax basis and if the aggregate of the partners' beginning and ending capital accounts differ from the amounts reported on Schedule L, attach a statement reconciling any differences. *No such reconciliation is required if Schedule L is not reported on the tax basis.*[45]

But Schedule M-2 will remain on the tax basis, as is clear in the instructions related to the balance at the end of the year section for Schedule M-2.

> The balance at the end of the year should equal the total of the amounts reported as the partners' ending capital accounts in item L of all the partners' Schedules K-1.[46]

[42] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, pp. 32
[43] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, pp. 32
[44] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, pp. 32
[45] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 56
[46] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 56

Partnerships Previously Reporting on a Method Other Than Tax Basis for Partners' Capital

Those partnerships that, in prior years, used a method other than tax basis to report partners' capital are given special instructions for this year. As was noted earlier, these partners will have to report partners' capital on Schedule K-1 on the tax basis this year per the draft Form 1065 instructions.

Last year partnerships that reported on a basis other than tax basis for partner's capital accounts did have to report negative tax basis capital accounts for any partners with such accounts. Thus, such partnerships may already have complete schedules of partners tax basis capital accounts calculated in which case those numbers should be used:

> If you reported partners' capital accounts using a method other than the tax basis method last year, but also maintained capital accounts in your books and records using the tax basis method (for example, for purposes of meeting the requirement to report partner negative tax capital accounts), you must report each partner's beginning capital account using the tax basis method.[47]

If the partnership did not maintain such tax basis records the IRS provides that such partnerships may refigure each partner's *beginning* capital account using one of the following methods, with the same method being used for each partner:

- Tax basis method;
- Modified outside basis method;
- Modified previously taxed capital method; or
- Section 704(b) method.[48]

The partnership must use the standard tax basis methods described previously to report all other items on Schedule L aside from the beginning partners' capital balances, so this represents a one-time only calculation to obtain a starting point for a partner's tax basis capital account.[49]

The following disclosures must also be made to each partner in this case as a statement attached to Schedule K-1:

> You must also attach a statement to the partners' Schedules K-1 indicating the method used to determine each partner's beginning capital account.[50]

The three methods aside from reconstructing the transaction tax basis capital accounts are described in the following sections.

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[47] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31
[48] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31
[49] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 31
[50] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 32

Modified Outside Basis Method

The first method for computing the partners' beginning tax basis capital accounts for the transition is the modified outside basis method. This method looks at the outside basis of each partner's capital account as a starting point.

The instructions describe the method as follows:

> The amount to report as a partner's beginning capital account under the modified outside basis method is equal to the partner's adjusted tax basis in its partnership interest as determined under the principles and provisions of subchapter K including, for example, Sections 705, 722, 733, and 742; and subtracting from that basis (1) the partner's share of partnership liabilities under Section 752 and (2) the sum of partner's Section 743(b) adjustments (that is, net Section 743(b) adjustments). For purposes of establishing a partner's beginning capital account, you may rely on the adjusted tax basis information provided by your partners.[51]

Assuming each partner can provide the partnership with this information, or the partnership has maintained such information for each partner, this provides a relatively simple method to make the conversion.

However, this method will in many cases not result in total partners' tax basis capital that will reconcile to net tax basis capital for a balance sheet prepared on the tax basis. Thus, the method may require, as a practical matter, that the Schedule L balance sheet continue to be reported on a basis other than tax basis.

Modified Previously Taxed Capital Method

The second method looks to make use of the method found in the regulations under Section 743 to compute "previously taxed capital" for use in computing a Section 743(b) adjustment for a partner. The method looks to start with the cash each partner would receive if all partnership assets were sold, and then adjust that number to take into account the gains and losses that would be reported by each partner related to that sale. Thus, the calculation is meant to determine each partners' share of the inside net tax basis of partnership property.

The instructions describe this method as follows:

> The amount to report as a partner's beginning capital account under the modified previously taxed capital method is equal to the following.
>
> - The amount of cash the partner would receive if you liquidated after selling all of your assets in a fully taxable transaction for cash equal to the fair market value of the assets; increased by
> - The amount of tax loss determined without taking into account any Section 743(b) basis adjustments (including any remedial allocations under Regulations Section 1.704-3(d)) that would be allocated to the partner following such a liquidation (treating all liabilities as nonrecourse); and decreased by

[51] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 32

- The amount of tax gain determined without taking into account any Section 743(b) basis adjustments (including any remedial allocations under Regulations Section 1.704-3(d)) that would be allocated to the partner following such a liquidation (treating all liabilities as nonrecourse).

> Instead of using the assets' fair market value, you may determine the partnership's net liquidity value, and gain or loss, by using such assets' bases as determined under Section 704(b), as determined for financial accounting purposes, or on the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management.[52]

If this method is used, the following additional information must be provided to the partner:

> If the modified previously taxed capital method is used, the statement must also include the method used to determine the partnership's net liquidity value (fair market value, Section 704(b) book value, etc.). The method used to determine the partnership's net liquidity value must be adopted for all partners in the partnership.[53]

Section 704(b) Method

While the prior two methods were described by the IRS in Notice 2020-43, the draft instructions add a brand-new method based on Section 704(b) capital accounts, referred to in the Section 704 regulations as "book capital" accounts.

The IRS describes this method as follows:

> The amount to report as a partner's beginning capital account under the Section 704(b) method is equal to the partner's Section 704(b) capital account, minus the partner's share of Section 704(c) built-in gain in the partnership's assets, plus the partner's share of Section 704(c) built-in loss in the partnership's assets. Property contributed to a partnership is Section 704(c) property if, at the time of the contribution, its fair market value differs from its adjusted tax basis. Section 704(c) property also includes property with differences resulting from revaluations (reverse Section 704(c) allocations). For more information see Sections 704(b) and 704(c) and Regulations Sections 1.704-1 through 1.704-3.[54]

Most partnership agreements drafted by legal counsel will require the maintenance of capital accounts under the Section 704(b) regulations or, in the case of target capital accounts, will provide what is essentially a yearly computation of that account that is used to determine income/loss allocations. The Section 704(b) capital accounts are important for a partnership to be able to defend any special allocations in the partnership agreement against an IRS challenge.

Again, this beginning "tax basis" capital account will often result in the total of the individual partner capital accounts not agreeing with the total of net tax basis capital on a balance sheet prepared on the income tax basis. So, again, this would be most appropriate in cases where the partnership plans to continue to report its Schedule L balance sheet on other than the tax basis.

[52] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 32
[53] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 32
[54] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 32

Special Beginning Tax Basis Capital Account Method for Publicly Traded Partnerships

Finally, the instructions conclude with the following special method for computing the partners' beginning capital account for a publicly traded partnership:

> In the case of a sale or exchange of an interest in a publicly traded partnership, you may determine a transferee partner's beginning capital account by adjusting the partner's beginning capital account to reflect the transferee partner's purchase price of the interest rather than entering the transferor partner's ending capital account. In making the adjustments, you may use information required to be reported to you under Regulations Section 1.6031(c)-1T, and publicly available trading price information. If you are a publicly traded partnership and adopt the modified previously taxed capital method, you may apply Regulations Section 1.743-1(j)(4)(i)(B)(2) in figuring a partner's beginning capital account.[55]

BASIS ISSUES

Beginning Basis

Initial basis in a partnership interest is determined by the manner in which the partner acquires an interest in the partnership. If an interest is acquired from the partnership by contribution of money or other property to the partnership, the partner's beginning basis is the sum of:

- money contributed to the partnership;
- the adjusted basis of other property contributed to the partnership; and
- any gain recognized under IRC Section 721(b) (IRC Section 722).

Note that the only adjustment for gain recognized is that recognized as a result of IRC Section 721(b), which is the gain required to be reported if the partnership is an investment company. Gains recognized from a deemed distribution relating to liabilities transferred to the partnership do not result in an increase in the partner's basis.

If a partnership interest is acquired other than by contribution of money or other assets to the partnership, the partner's beginning basis in his partnership interest is determined under the general rules for determining the basis of any asset (IRC Section 742). If acquired by purchase, the basis is cost (IRC Section 1012). If acquired by gift, the partner's basis is the donor's adjusted basis increased by any gift tax paid by the donor attributable to the interest (IRC Section 1015). If the interest is acquired from a decedent, the partner's basis is the value at which the partnership interest is included in the decedent's estate tax return, increased by the decedent's share of partnership liabilities and decreased by any amount that constitutes an item of income in respect of a decedent (IRC Sections 1042(a) and (c) and 1014).

If a partner receives an interest in the partnership in exchange for services, the beginning basis in the partnership interest is the amount of income required to be reported on the transaction. The partnership is deemed to have paid the individual for services in cash, and the individual then contributes an equal amount of cash to the partnership in acquisition of an interest in the partnership.

[55] 2020 Instructions for Form 1065, U.S. Partnership Return of Income, p. 32

The transfer of a partnership interest to a creditor in satisfaction of a debt owed to the creditor can create income under the provisions of IRC Section 108(e)(8). Under Reg. Section 1.108-8, the debt is treated as satisfied for an amount of money equal to the FMV of the interest. If that value is less than the outstanding debt, cancellation of debt income is recognized by the partners of the partnership immediately before the discharge.

The regulation provides at Reg. Section 1.108-8(b)(1) that, generally, all facts and circumstances are considered when determining the FMV of the interest transferred. However, the regulation provides for a liquidation value safe harbor FMV interest if all of the following four conditions are satisfied.

- The creditor, debtor partnership, and its partners treat the FMV of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange.
- If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the FMV of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value.
- The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests.
- Subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest and no person bearing a relationship to the debtor partnership or its partners who is specified in Section 267(b) or Section 707(b) purchases the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of cancellation of debt income by the debtor partnership (Reg. Section 1.108-8(b)(2)(i)).

Liquidation value is defined as the cash the creditor would receive if all assets of the partnership (tangible and intangible) were sold for cash equal to the fair value of the asset and the partnership then liquidated (Reg. Section 1.108-8(b)(2)(iii)).

Subsequent Adjustments

After determining a partner's beginning basis in her partnership interest, annual adjustments are required for items reported to the partner on Form K-1.

A partner's basis is increased by IRC Section 705(a)(1) for the following:

- Subsequent contributions of cash or other property
- Taxable income of the partnership
- Tax-exempt income of the partnership
- The amount by which depletion deductions exceed the basis of the properties subject to depletion

The basis is decreased (but never below zero) by IRC Section 705(a)(2) for the following:

- Distribution of cash or other property
- Losses of the partnership
- Expenditures that are not capital in nature but are not deductible by the partnership (sometimes called "nondeductible current expenditures")
- Allowable depletion deductions on oil and gas properties to the extent of the basis of the properties

The adjustments required for taxable income and losses are relatively straightforward. Since a partner is subject to taxation on her share of partnership taxable income whether or not it is distributed, the positive adjustment is necessary to avoid double taxation when the cash is actually distributed or when the partnership interest is sold. Conversely, negative adjustments assure that deduction of losses is limited to basis and avoids claiming a double loss.

In terms of the ordering of the deductions, Reg. Section 1.704-1(d)(2) provides that basis for loss deductibility purposes must be reduced by items found in IRC Section 705(a)(2). Section 705(a)(2) includes expenditures not deductible in computing taxable income and not chargeable to a capital account.

Nondeductible expenditures meet the criteria found in IRC Section 705(a)(2)(B), which are contained in IRC Section 705(a)(2). Thus, it appears that nondeductible items reduce basis prior to allowable deductions. This is a different result that occurs with an S corporation.

The adjustment for tax-exempt income avoids converting tax-exempt income into taxable income.

The reduction in basis for noncapital but nondeductible expenditures is required for exactly the same reasons. Failure to reduce basis for such expenditures would, in effect, make them deductible upon sale or liquidation of the partnership. Of concern in this area is the proper treatment of syndication costs. Common practice is to treat such expenditures as capital costs. This takes them outside of IRC Section 705(a)(2)(B) and prevents the reduction of basis. In practice, capitalizing these costs frequently enables partners to deduct other losses that would otherwise exceed their basis.

Two adjustments regarding depletion are related but separate problems. Depletion on mineral properties is allowable even though the total depletion deductions may exceed the tax basis of the property being depleted. A positive adjustment, therefore, is required to preserve the benefit of this depletion deduction for a partner in those instances where depletion is taken as a deduction by the partnership.

For oil and gas properties, partnerships are prohibited from claiming any depletion deductions. Instead, the individual partners must calculate and deduct their depletion as if they owned the properties outside of the partnership. A negative adjustment, therefore, is required to prevent a double deduction relating to those properties.

EFFECT OF LIABILITIES ON A PARTNER'S BASIS

In General

The preceding discussion stated that cash contributions increase a partner's basis in a partnership interest while cash distributions decrease the basis. A cash contribution, as used here, includes not only actual cash contributed to the partnership but also any increase in the partner's share of partnership liabilities. Furthermore, the partner's assumption of a liability of the partnership or receipt of partnership property subject to a liability is also treated as a cash contribution to the partnership (IRC Section 752(a)). In like manner, if there is any decrease in a partner's share of partnership liabilities, assumption by the partnership from the partner of a liability is treated as a cash distribution from the partnership to the partner (IRC Section 752(b)).

Definition of a Liability

Under prior law, partnership liabilities included not only those liabilities recorded on the books and records but also those not recorded, such as trade payables and accrued expenses on a cash-basis partnership.

Such a treatment is no longer the case. Current Reg. Section 1.752-1(a)(4) treats an obligation as a liability only to the extent that incurring or holding that obligation gives rise to:

- the creation of, or increase in, basis of an asset (including cash) owned by the obligor;
- a deduction taken into account in determining taxable income of the obligor (trade creditors for accrual basis taxpayers); or
- an expenditure that is not deductible for computing taxable income and is not properly chargeable to capital (IRC Section 705(a)(2)(B) expenditures).

Note that a cash basis taxpayer's accounts payable does not give rise to any of the listed items and, therefore, would not be a liability under this rule.

Contingent Liability Anti-Abuse Rule

Contingent liabilities do not give rise to partnership basis under Section 752. That fact had been used in certain marketed tax shelters sold in the late 1990s (most famously, the "Son of BOSS" transactions), in the IRS's view, to "manufacture" artificial basis by having taxpayers acquire and contribute options they had sold, which had a potential liability to repay the balance. At the same time the taxpayers would buy an option with the proceeds structured in such a way to effectively remove a chance for a net gain or loss.

In response, the IRS-issued Reg. Section 1.752-6, which provides that if the partnership assumes a liability (defined as "any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of this title" by reference to IRC Section 358(h)(3)) that is not taken into account under Section 752, the taxpayer's basis in his partnership interest is reduced (but not below zero) by the amount of such a liability.

Recourse Liabilities (Reg. Section 1.752-2)

A recourse liability of a partnership is defined as any obligation to the extent that any partner bears an economic risk of loss with regard to that obligation (Reg. Section 1.752-1(a)(1)). A partner bears an economic risk of loss with respect to a liability to the extent the partner is obligated to make a payment either to the creditor, the partnership, or any other person if the liability is not satisfied and the partner is not entitled to repayment of such amount.

A partner also bears an economic risk of loss with respect to any liability on which he (or a person related to him) is the creditor (Reg. Section 1.752-2(c)). A related party's obligation to make a contribution, et cetera, is treated as the partner's obligation. A related party is defined under IRC Section 267(b) or IRC Section 707(b)(1) with some modifications.

Allocation of Recourse Liabilities

Having determined that a liability is a recourse liability because at least one partner has an economic risk of loss, the liability is then allocated among the partners based upon their relative economic risk on that liability. This approach eliminates many of the problems that existed before the regulation was adopted, but it makes it much more difficult to create basis with liabilities that have no economic risk.

The method of allocation for recourse debts is based on a constructive liquidation scenario (also known as the "atom bomb" scenario) under Reg. Section 1.752-2(b), which requires a six-step process.

- All partnership assets are deemed worthless, including cash.
- The assets are sold for their FMV of zero, including cash.
- Losses are allocated to the partners in accordance with their loss ratios. These reduce the partners' capital accounts.
- Any partner with a deemed negative capital account after the reduction in basis is treated as contributing cash in restoration of the negative balance.
- The cash deemed contributed is used to pay the liabilities.
- The partnership is liquidated and any remaining cash is distributed to those with positive capital accounts.

The amount of each partner's deemed cash contribution used to pay the recourse liabilities is that partner's allocable share of recourse liabilities. In determining whether a partner is obligated to make a payment to a creditor or a contribution to the partnership, all of the following statutory and contractual obligations are considered:

- Contractual obligations outside of the partnership agreement, such as indemnifications, guarantees, or other agreements running directly to a creditor or to the partnership
- Obligations imposed by the partnership agreement, including the obligation to make a capital contribution to restore a deficit capital account

- State law obligations, including those in the state partnership statute (Reg. Section 1.752-2(b))

Disregarded Entities & Recourse Debt Allocations

If a partner of the partnership is a disregarded entity (such as a single member LLC), additional rules apply in determining the deemed cash contribution. Per Reg. Section 1.752-2(k), the disregarded entity's deemed payment under Reg. Section 1.752-2(b)(1) is limited to its net value on the applicable allocation date. The net value is generally the FMV of the disregarded entity's assets as of the allocation date, less the value of any assets pledged and counted under Reg. Section 1.752-2(h)(1) and reduced by the liabilities of the entity (other than Reg. Section 1.752-2(b)(1) payment obligations).

Thus, a disregarded entity is not assumed automatically to meet its legal obligation to supply cash to restore its deemed negative capital account, but rather is tested for its presumed ability to make that repayment. Note the distinction in treatment versus that assumed for a thinly capitalized partner that is not a disregarded entity, where it is generally assumed the thinly capitalized partner would meet the obligation.

The regulations require that the partnership obtain this information from its partners in order to perform this calculation. In issuing the final regulations, the IRS specifically rejects providing for any assumptions to be made by the partnership about the partners in this case.

Effect of Guarantees

A partner does not automatically increase basis by guaranteeing partnership debt. The deemed liquidation rule will determine which partner is liable for any recourse obligations.

EXAMPLE

Limited Partner Guarantee

Greg and Lucy form the Highfly Limited Partnership. Greg will be the general partner and Lucy will be the limited partner. Each partner contributes $10,000 to the partnership, and the partnership acquires $100,000 in assets utilizing the cash contributed and $80,000 in recourse debt. The bank requires Lucy to guarantee the debt. The partnership provides that Greg and Lucy will share all profits and losses equally. This is true even though Lucy is economically responsible for the debt. The only way for Lucy to obtain basis from the debt would be for her to enter into a loan assumption agreement whereby she would become personally responsible for the debt.

Under the regulations, several alternatives are possible with a little planning.

- If, upon payment, Lucy becomes subrogated to the bank's claim against the partnership, the entire debt would be allocable to Greg. This occurs because Lucy would have legal recourse against Greg as the general partner for reimbursement in full. His guarantee in this case is an accommodation to the bank for collection and does not change the ultimate responsibility for repayment.
- If Lucy has no right to contribution or recovery from Greg, the entire debt would be allocable to Lucy since she bears the ultimate economic risk.
- The partners could agree that Greg would reimburse Lucy for half of any payments he was required to make under his guarantee. In this instance, the debt would be allocated equally between Greg and Lucy.

An interesting question arises with respect to the first scenario described. Would the same result occur if it was clear that, even though Greg was legally liable, Lucy would bear the ultimate responsibility because

Greg was not financially stable? As a general rule, the regulations assume that partners will satisfy their legal liabilities (Reg. Section 1.752-2(b)(6)). This rule won't apply where there is a plan to circumvent or avoid the obligation.

One example in the regulations explores this type of problem where the general partner is a corporation established solely to be a general partner and is funded with only enough assets to make its initial capital contribution. In this situation, the economic realities prevail and the debt would be allocable to Lucy (Reg. Section 1.752-2(f) Ex. 3).

Disproportionate Capital Account Issues

When partners have capital accounts that are not in proportion to their interest in partnership profits and losses, allocation of recourse debt may create problems.

Some of the problems have been resolved by the regulations, but problems still exist, as demonstrated in the following two examples.

EXAMPLE

Disproportionate Capital Accounts

Assume that Drake and Bart form the Gopher General Partnership with contributions of $20,000 each. The partnership agreement provides for all profits and losses to be allocated 90% to Drake and 10% to Bart. It further requires that distributions in liquidation be based upon positive capital account balances and that any partner with a deficit capital account balance must restore that deficit on liquidation. The partnership incurs $60,000 in recourse debt and acquires $100,000 in assets. Who has the economic risk associated with this debt?

To determine this allocation, the regulations assume a worst-case situation in which the assets acquired immediately become worthless and the partnership is liquidated. The capital accounts would appear as follows:

	Drake	Bart	Total
Contribution	$20,000	$20,000	$40,000
Loss of sale of assets	–$90,000	–$10,000	–$100,000
Capital accounts at liquidation	–$70,000	$10,000	–$60,000

Drake would be responsible for repaying all of the debt plus contributing $10,000 to repay Bart's capital account balance.

Therefore, Drake is economically at risk for the debt and it would be allocated entirely to him.

EXAMPLE

Disproportionate Capital Accounts: No Debt

Assume Alan and Sal each have a $10,000 deficit capital account in the Seller General Partnership. The partnership has a $20,000 recourse liability and Alan and Sal share all profits and losses equally. Alan contributes $20,000 to the partnership to liquidate the partnership debt.

It is agreed that Alan will be entitled to the first $20,000 in cash distributions or, if Sal makes subsequent contributions, to an amount of preferential distributions to equalize their capital accounts. If the partnership is liquidated while the capital accounts are unequal, Sal must pay Alan the amount required to equalize their capital accounts.

These transactions are reflected in the partner's basis as follows:

	Alan	Sal	Total
Capital account balance	–$10,000	–$10,000	–$20,000
Allocation of partnership liabilities	$10,000	$10,000	$20,000
Beginning basis	0	0	0
Contribution	$20,000	0	$20,000
Deemed distribution from payment of liability	–$10,000	–$10,000	–$20,000
Preliminary ending basis	$10,000	–$10,000	0

Remember that since basis can never be less than zero, the information in the table is not the true ending basis. Rather, there remains a tax event to be recognized to remove the "impossible" negative basis.

Since Sal cannot have negative basis, she must recognize $10,000 of taxable income from the deemed distribution. This is true even though she has an obligation to repay Alan since there is no partnership liability to allocate to her to create basis.

In this instance, Alan should loan the money to the partnership rather than make a capital contribution (see IRC Section 707 regarding loans from a partner to the partnership).

Nonrecourse Liabilities

A liability is nonrecourse to the extent that no partner bears the risk of economic loss. A purported nonrecourse liability is treated as recourse to the extent that any partner has guaranteed or otherwise obligated himself for repayment, but it is a nonrecourse liability to the extent that the total liability exceeds such guarantee or other obligations (Reg. Section 1.7521(a)(2)).

Allocation of Nonrecourse Liabilities

Once the amount of a nonrecourse liability is determined, it is allocated among the partners so that each partner's share of that liability is the sum of the following:

- First tier—the partner's share of partnership minimum gain (determined under the IRC Section 704(b)regulations)
- Second tier—that partner's share of gain determined under IRC Section 704(c) or in the same manner as under IRC Section 704(c) in the case of a revaluation of partnership assets under IRC Section 704(b)
- Third tier—that partner's proportionate share of the excess nonrecourse liabilities of the partnership, generally based on the partner's profit ratio; however, the excess nonrecourse liabilities need not be allocated on the same method each year (Reg. Section 1.752-3(a))

Minimum Gain

Minimum gain is simply the amount by which the principle amount due on a nonrecourse liability exceeds the partnership's basis in the property (after considering all depreciation or amortization deductions attributable to that property) that serves as collateral for the debt. This presumes that the property will be sold for the amount of the nonrecourse debt only. Note that the FMV of the property isn't considered in this computation, only the balance due on the nonrecourse debt. Only when there is an increase in minimum gain for a year will there be any deductions or losses deemed allocable to nonrecourse debt. Minimum gain is determined on a property-by-property basis.

Excess Nonrecourse Liabilities

The partner's proportionate share of the excess nonrecourse liabilities of the partnership is determined by multiplying the total excess nonrecourse liabilities of the partnership (total nonrecourse liabilities reduced by those amounts specifically allocated to individual partners) by the partner's interest in partnership profits. The partner's interest in partnership profits is determined by taking into consideration all of the facts and circumstances relating to the economic arrangement of the partners. The excess nonrecourse liabilities can also be allocated in accordance with the way in which any deductions attributable to those liabilities will be allocated. If the partnership agreement specifies the partners' interests in partnership profits for purposes of sharing nonrecourse liabilities and that allocation ratio is reasonably consistent with allocations of significant items that have substantial economic effect, that allocation will be deemed to be the partners' interests in partnership profits (Reg. Section 1.752-3(a)(3)).

In 2004, the IRS issued TAM 200436011, in which it concluded that an allocation of excess nonrecourse liabilities could not be based on an allocation based on gross income. According to the TAM, gross income isn't a significant item of income or gain. The allocation of excess nonrecourse liabilities must be based on a particular type or character of income or gain (i.e., tax-exempt income or gain from the sale of property).

The regulations (Sections 1.752-3(a) and (b) and 1.752-5) modify the allocation relating to the third tier to allow the portion of third-tier allocation to be allocated based upon the Section 704(c) gain attributable to the property but not allocation in tier two.

This is caused when the Section 704(c) gain allocated to a partner in tier two exceeds the partner's share of nonrecourse liabilities allocated to that tier (e.g., if the property contributed has been refinanced and the refinance is secured by multiple properties).

The regulations provide that when multiple properties are used to secure a single loan, the liability may be allocated among the properties based upon any reasonable method, provided that the amount allocated does not exceed the FMV of the property.

De Minimis Rules for Guarantees

Generally, nonrecourse loans are considered recourse to the extent that a partner ultimately guarantees them and only that partner can increase her basis. Under the de Minimis rule, a partner is not treated as having an economic risk of loss on a partnership loan if:

- the partner owns an interest in the partnership income, gain, loss deduction, and credits of10% or less; or

- the loan would otherwise be qualified nonrecourse financing under the at-risk rules of IRC Section 465.

The difference between this and the situation described in the earlier example in the effect of guarantees in the recourse debt portion of this module is that here we are assuming that the partner is guaranteeing a debt that otherwise would be nonrecourse. In the earlier example, the general partner remained personally liable even though another partner signed a guarantee.

EXAMPLE

Nonrecourse Debt Allocations: Guarantees

Hal and Nick each contribute $100,000 to form a general partnership to acquire a hotel. They agree to share profits and losses equally. The partnership purchases the hotel for $2,000,000 utilizing $1,800,000 of nonrecourse debt. Hal guarantees the nonrecourse debt to the extent of repaying the bank 50% of any loss it incurs. Hal has no right to reimbursement from the partnership or from Nick for any payments he is required to make under the guarantee.

To the extent of Hal's guarantee, the debt is treated as recourse debt. The balance of the debt is a nonrecourse liability and should be allocated equally based upon the profit-sharing ratios.

	Hal	Nick	Total
Recourse debt: economic risk	$900,000	$0	$900,000
Nonrecourse debt: profit sharing	$450,000	$450,000	$900,000
Total debt allocation	$1,350,000	$450,000	$1,800,000

EXAMPLE

Nonrecourse Debt Allocations: Minimum Gain

Rex and Pat form an LP to acquire and operate an office building. Rex, as general partner, contributes $20,000 and Pat, as limited partner, contributes $180,000. The partnership obtains

$800,000 in nonrecourse financing on which no principal payments are due for five years and purchases the building on leased land for $1,000,000.

The partnership agreement provides the following:

- Capital accounts will be maintained as required by the 704(b) Regulations.
- Liquidating distributions will be based on positive capital accounts.
- Any partner with a deficit capital account at liquidation must restore the deficit balance.
- A minimum gain chargeback provision is included (the concept of minimum gain is explained shortly).
- Profits will be allocated 50% to Rex and 50% to Pat.
- Losses will be allocated 10% to Rex and 90% to Pat.
- The minimum gain chargeback provision requires that all partnership items will be allocated 10% to Rex and 90% to Pat.
- After the partnership has recognized items of income and gain equal to its cumulative losses and deductions, all future partnership items will be allocated equally between the partners.

- The agreement specifies that the partners have equal interest in partnership profits for purposes of allocating nonrecourse liabilities.

In each of its first three years, the partnership recognizes an $85,000 loss that includes a depreciation deduction of $90,000.

Year 1:

The partnership has no minimum gain chargeback since the basis in partnership assets ($910,000) exceeds the nonrecourse debt ($800,000). The nonrecourse debt is allocated based on the partners' interests in partnership profits as specified in the partnership agreement.

Each partner is allocated $400,000 of nonrecourse debt.

Year 2:

The partnership has no minimum gain chargeback since the basis in partnership assets ($820,000) exceeds the nonrecourse debt ($800,000). The nonrecourse debt is allocated based on the partners' interests in partnership profits as specified in the partnership agreement.

Year 3:

The partnership has a minimum gain chargeback of $70,000, which is the excess of the nonrecourse debt ($800,000) over the basis in partnership assets ($730,000) at the end of the year. The nonrecourse liabilities are first allocated to the partners based upon their share of the minimum gain chargeback (10% : 90%), with the excess nonrecourse liabilities being allocated based upon the partner's interests in partnership profits as specified in the partnership agreement.

The allocation of the nonrecourse debt at the end of Year 3 is as follows:

	Rex	Pat	Total
Minimum gain chargeback	$7,000	$63,000	$70,000
Profits interest	$365,000	$365,000	$730,000
Total debt allocation	$372,000	$428,000	$800,000

It should be noted that the minimum gain allocation does not require recognition of income for the minimum gain, but rather is used for this purpose as an allocation of nonrecourse debt. However, gain may need to be recognized at a later time.

ALTERNATIVE RULE FOR DETERMINING BASIS (REG. SECTION 1.705-1(B))

The general rules for determining a partner's basis in his partnership interest anticipate that a basis calculation will be made each year. In reality, a CPA often finds a basis calculation was not made unless there is some specific reason for doing so when beginning to represent a new client.

It may be very difficult to do a basis calculation at this point simply because the partnership has been in existence for a period of years and the records to reflect each of the adjustments required under IRC Section 705(a) are no longer available.

Recognizing this problem, an alternate method for calculating basis is provided where:

- circumstances are such that the general rule of IRC Section 705(a) cannot practicably apply; and
- in the opinion of the Commissioner, the result obtained will not vary substantially from the result if the general rule had been applied (Reg. Section 1.705-1(b)).

The basis of partnership assets that would be distributed to the partner in liquidation of the partnership is the starting place for applying the alternate rule for determination of partner basis. In a simple partnership (all partners contributed only cash and there have been no distributions or transfers that affected basis calculations), this step is all that is required.

EXAMPLE

Simple Partnership

Ted, Bob, and Dan each contributed equal amounts of cash to the Easygo partnership. Over the years, no distributions of cash have generated taxable income and there has been no distribution of property.

On December 31, 20XX, the books of the partnership, on a tax basis, reflect the following:

Total Assets	$15,000
Liabilities	$3,000
Capital Accounts	
Ted	$4,000
Bob	$4,000
Dan	$4,000
Total Capital	$12,000
Total Liabilities and Capital	$15,000

If liquidated on a pro rata basis on December 31, 20XX, each partner would receive assets with a tax basis of $5,000. Another way to determine the same amount would be to add to each partner's tax basis capital account ($4,000) his share of partnership liabilities ($1,000).

If the partnership is not a simple partnership, adjustments may be necessary to the basic calculation to determine the partner's adjusted basis.

EXAMPLE

Use of the Alternative Method on Purchase of a Partnership Interest

Assume in the facts in the preceding example that Dan was not one of the original partners, but had acquired his interest from an original partner in a transaction for which no 754 election was in effect. Therefore, Dan's capital account really reflects the prior partner's basis rather than Dan's basis.

If the prior partner sold his interest to Dan at a tax gain of $3,000, Dan's basis is calculated as follows:

Dan's basis as calculated in prior example	$5,000
Adjusted for acquisition from prior partner align	$3,000
Dan's basis	$8,000

The alternate method is not a carte blanche for estimating a partner's basis. The burden is on the taxpayer to show that it is reasonable to believe that the result will not be substantially different from what it would have been had the general method been applied. Use of the alternate method was denied where there was no satisfactory evidence as to the partnership's tax basis in the property used in the calculation (*Colomon v. Commissioner*, 540 F.2d 427 (CA 9, 1976)).

Most tax-preparation packages used by CPAs today provide a method to track a taxpayer's basis either as part of the partnership return preparation engagement, as part of the preparation of the individual return, or both. As such, a failure to maintain basis records may open the CPA to potential liability to the client for failure to exercise proper care, a charge by a state board or the Office of Professional Responsibility for a lack of a due diligence, or both.

If the CPA does not calculate the taxpayer's basis in the partnership interest, it may be reasonable to ask how the CPA determined either that the taxpayer was allowed to take any claimed loss or how it was determined that there had been no gain triggered by any distribution from the partnership—including distributions created by a reduction in debt allocated to the partner.

The alternate method provides an option for CPAs that take over clients where basis records either have not been maintained or are not available to determine a starting point for basis calculations.

Since the IRS has already inserted a requirement to provide a basis calculation in the Schedule E instructions when a loss is claimed from an S corporation pass-through, it seems likely that eventually a basis calculation will also be a required attachment for partnership losses.

Unit 3

Formation Traps

LEARNING OBJECTIVES

- **Identify** and **address** those situations where the partners must recognize income onthe formation of a partnership.
- **Identify** and **address** the problems associated with the transfer of appreciated property toa partnership.
- **Identify** and **address** the issues associated with the contribution of services to a partnership in exchange for a partnership interest.

While seemingly easy to form, there are a few tax traps that await the unwary in the creation of a partnership. These traps include the recognition of income on the transfer of securities to certain partnerships, the allocation of gain and future depreciation where appreciated property is transferred to a partnership, and the tax consequences of a transfer of a partnership interest in exchange for services rendered by a partner.

Despite these complexities, the creation of a partnership is still relatively simple when compared to the incorporation of a new corporation.

INVESTMENT COMPANY

One of the few exceptions to the nonrecognition of gain on the formation of a partnership arises if a transfer is deemed to be made to an investment company. The idea of these rules is to prevent a taxpayer from effectively diversifying a nondiversified investment portfolio without paying a capital gains tax on the disposition of the nondiversified positions.

Definition of a Section 721(b) Investment Company

An investment company is defined in IRC Section 351(e)(1) and Reg. Section 1.351-1(c)(1).

Under IRC Section 721(b), gain will be recognized if a partnership would be an investment company (under IRC Section 351) if it was a corporation. To effectively meet this test, there are two issues to be considered.

- First, are the partnership's assets composed (to a significant extent) of investment assets?
- Second, will the proposed transfer result in diversification of the transferor's interests?

Assets of the Partnership Test

To meet the first prong of the test, more than 80% (determined by value) of the partnership's assets after the transfer must be comprised of specific assets that generally would be viewed as investment assets.

The proscribed assets whose post-contribution values must be totaled are the following:

- Cash
- Corporate stock or securities
- Evidence of indebtedness
- Foreign currency
- Notional contracts
- Options
- Precious metals, unless the partnership uses them in the partnership's trade or business
- Interests in publicly traded partnerships, mutual funds, or real estate investment trusts
- An interest in any other entity if substantially all of the assets of the entity are comprised, directly or indirectly, of assets listed here; since regulations in this area haven't been issued yet, the substantially all test (using 90%) as set forth in the Senate Committee Report from the enactment of Section 351 (PL 96-589) would appear to apply.

Impermissible Diversification

If the partnership is composed of a sufficient concentration of impermissible assets, the partner's contribution is scrutinized to determine if the partner's contribution will result in diversification. Diversification occurs when two or more partners transfer nonidentical assets to the partnership in exchange for partnership interests (Rev. Rul. 88-32). Unless the partners are each giving cash, this part of the test will be met. But there is another issue to be considered—were the partner's assets being contributed already diversified.

There will be no diversification where the interests transferred are already diversified. The interests will be deemed to be diversified if no single stock, security, et cetera, comprises more than 25% of the portfolio's fair market value (FMV) and no five stocks, securities, et cetera, comprise more than 50% of the portfolio (Reg. Section 1.351-1(c)(6)).

If the investment company rules apply, gains will be recognized, but losses may be deferred if the family attribution rules of IRC Sections 267(b) and 707(b)(1) apply. The gains are recognized by the individual partners, not by the partnership. Thus, the initial basis of the partners in their partnership interest will be the FMV of the property transferred since the recognition of gain will increase the partners' basis in the property contributed to FMV.

Likewise, the partnership's basis in the property will be its FMV.

Exposure upon Later Distribution of Property

Even if immediate gain recognition is avoided when contributing appreciated securities to a partnership, subsequent distributions of property from the company within seven years of the

contribution to another partner triggers gain or loss to the contributing partner under the general appreciated property distribution rule of IRC Section 704(c)(1)(B) (see Reg. Section 1.704-4(a), except note that it does not reflect the revision of the period from five years to seven years). Note that gain will be recognized upon a subsequent sale to a third party under the IRC Section 704(c) rules discussed later in this manual. The partner receiving the property has a basis in the property equal to the partnership's basis plus or minus the gain or loss recognized by the contributing partner.

CONTRIBUTED PROPERTY: ALLOCATIONS UNDER IRC SECTION 704(C)

As previously discussed, a partnership's tax basis in contributed property is the tax basis of the contributing partner immediately prior to the contribution. Immediately after the contribution, the assets lose their identity with the contributing partner and the entity concept applies for purposes of calculating gain or loss on sale, depreciation, et cetera, with respect to those assets. This then becomes a partnership item, which is allocated among the partners, with pre-contribution gain being allocated to the contributing partner.

Prior to regulations under Section 1.704-3, this would have provided partners with an opportunity to shift income for tax purposes without impacting their economic sharing arrangements as illustrated in the following examples.

EXAMPLE

Contribution of Appreciated Property: Pre-Reg Section 1.704-3

Assume that Luke and Dan form a general partnership with the following contributions:

	Tax Basis	Fair Market Value
Luke: Contribution of Cash	$10,000	$10,000
Dan: Contribution of XYZ stock purchased years earlier	$2,000	$10,000

It is agreed that the partners will share all items of income, gain, loss, deduction, and credit equally and that liquidation will be based upon capital accounts reflecting contributed property at FMV. Shortly after formation of the partnership, the XYZ stock is sold for its FMV of $10,000 and the total cash in the partnership is invested in DEF stock.

This stock is sold three years later for $40,000 and the cash distributed to the partners in liquidation of the partnership.

In year one, the partnership has a taxable gain of $8,000 but no economic gain. The taxable gain would be allocated equally between the partners, and Luke would be taxed on $4,000 of gain attributable to appreciation, which occurred while Dan owned the stock. In year four, there are economic and taxable gains of $20,000 allocated equally between the partners.

Over the term of the partnership, the economic and taxable gains recognized are as follows:

	Luke		Dan	
	Economic Gain (Loss)	Tax Gain (Loss)	Economic Gain (Loss)	Tax Gain (Loss)
Formation	$0	$0	*$8,000	$0
Sale of XYZ	0	4,000	0	4,000
Sale of DEF	10,000	10,000	10,000	10,000
Liquidation of partnership	0	**–4,000	0	***4,000
Total Net Gain	$10,000	$10,000	$18,000	$18,000

*Inherent economic gain already existing in the stock when it was contributed

**$20,000 cash received less basis of $24,000 ($10,000 original plus $14,000 allocated gain)

***$20,000 cash received less basis of $16,000 ($2,000 original plus $14,000 allocated gain)

Over the term of the partnership, the economic and tax gains are equal, but the timing and character of the gains or losses recognized for tax purposes may be substantially changed.

Dan defers, until the partnership is dissolved, half of the gain which arose while he held the stock. Luke, on the other hand, recognizes gain when the XYZ stock is sold and receives a loss deduction in an equal amount upon partnership liquidation.

EXAMPLE

Contribution of Appreciated Depreciable Property

Contributions are as follows:

	Tax Basis	Fair Market Value
Luke: Contribution of Cash	$10,000	$10,000
Dan: Equipment	$2,000	$10,000

It is agreed that the partners will share all items of income gain, loss, deduction, and credit equally and that liquidation will be based upon capital accounts reflecting contributed property at FMV. The equipment is depreciated over four years and on a straight-line method. After two years, the equipment is sold for its FMV of $5,000 and all cash is distributed equally in liquidation. Net income and cash flow without regard to depreciation were $2,000 for each of the two years of operations.

Over the term of the partnership, the economic and taxable incomes are recognized as follows:

	Luke		Dan	
	Economic Gain (Loss)	Tax Gain (Loss)	Economic Gain (Loss)	Tax Gain (Loss)
Formation	$0	$0	$8,000	$0
Year 1				
Cash Flow	1,000	1,000	1,000	1,000
Depreciation	–1,250	–250	–1,250	–250
Income (Loss)	-250	750	–250	750
Year 2				
Cash Flow	1,000	1,000	1,000	1,000
Depreciation	–2,500	–250	–1,250	–250
Sale of equipment	0	2,000	0	2,000
Income (Loss)	–250	2,750	–250	2,750
Liquidation	0	–4,000	0	4,000
Total Net Gain	–$500	–$500	$7,500	$7,500

Over the term of the partnership, the economic and tax gains and losses are equal, but again the timing and character of the gains and losses recognized for tax purposes may be substantially changed.

The example just listed reflects the general rule under IRC Section 704(c)(1) for allocations relating to property contributed to a partnership. The inequities are clear. The effect was that contributed property was treated in the same manner as assets purchased by the partnership.

Although this rule was changed for asset contributions after March 31, 1984, the effect of the old rule continues for all partnerships in existence with asset contributions prior to that date. Given the passage of time, though, few partnerships will likely be encountered that are still operating with assets covered by the pre-1984 rules.

Revised Section 704(c) Regulations

The regulations were changed to prevent the issues discussed earlier from occurring. Under revised regulations, partnerships:

- make what was previously an elective allocation related to depreciation, depletion, and gain or loss on contributed property under IRC Section 704(c)(2) mandatory; and
- expand the allocation to include all times of income, gain, loss, and deduction, including such items as unrealized receivables or payables.

Regulations to Deal with Effects of the Ceiling Rule (Reg. Section 1.704-3)

The final regulations implemented changes allowing taxpayers to overcome difficulties associated with the old "ceiling rule," which provided that allocations of depreciation to noncontributing partners were limited to the amount of available tax depreciation. Thus, noncontributing partners could be penalized if the contributing partner had a low basis in his property and the resulting allocation to the noncontributing partners did not equal the depreciation they would have been allocated had the partnership purchased the property for its FMV.

Before these regulations, the IRS contended that total depreciation could never exceed a ceiling amount and did not allow depreciation to be allocated in excess of tax basis. The total income, gain, loss, or deduction to be allocated to the partners with respect to a property cannot exceed the amount of such items realized for tax purposes by the partnership with respect to that property. The ceiling rule causes book-tax distortions when a tax item is less than the comparable book item allocated to the noncontributing partner. The ceiling rule applies to property with built-in gain when the tax depreciation for the period is less than the noncontributing partner's share of book depreciation for that period.

Reg. Section 1.704-3(a)(1) provides that a partnership may account for the built-in gain or loss on its Section 704(c) property through any reasonable method that is consistent with the purpose of Section 704(c). Section 704(c)'s purpose is to ensure that the contributing partner receives the tax burdens and benefits of any built-in gain or loss. The principal methods recognized in the final regulations as being generally reasonable include the following:

- the traditional method
- the traditional method with curative allocations
- remedial allocation method

These methods are each discussed in the following sections.

De Minimis Adjustment Exception

Partnerships must maintain two sets of books where property has been contributed to the partnership. Reg. Section 1.704-3(e)(1) provides that the partnership need not account for the built-in gain by property allocation of both the tax depreciation and the gain on the sale if the built-in gain constitutes only a "small disparity." A small disparity exists when the difference between the book value of all property contributed by one partner does not differ from the adjusted tax basis by more than 15% and the total gross disparity does not exceed $20,000 (Reg. Section 1.704-3(e)(1)).

The good news is that a partnership can ignore any IRC Section 704(c) allocations if the result is a de Minimis adjustment. To be a de Minimis adjustment, both of the following criteria must be met:

- The difference between the FMV and basis of all properties contributed by the partner during the year is 15% or less of the properties' bases.
- The total difference between the FMV and bases of all of the properties contributed by the partner during the year isn't in excess of $20,000.

If a partner's contribution qualifies for this exception, then the gain or loss can be allocated without considering precontribution gain upon the later disposition of the property.

The Traditional Method

Generally, Section 704(c) requires that partnership gain be allocated to the extent of precontribution gain to the contributing partner. Any excess gain would be allocated among all of the partners in accordance with their profit interests in the partnership. When combined with allocations of tax depreciation, this constitutes the traditional method of allocation.

EXAMPLE

The Traditional Method

Tom contributes property with a basis of $4,000 and an FMV of $8,000. There is a pre- contribution gain of $4,000. If the partnership sells the property for a gain of $5,800, $4,000 of the gain would be specifically allocated to Tom, and $1,800 of the gain would be allocated to all of the partners in the ratio in which they share income.

If the property is depreciable, those contributing cash should be entitled to depreciation based upon the depreciation they would have received if the property had been purchased at its FMV by the partnership. The effect of this rule is to make the noncontributing partner indifferent for tax purposes, whether the partnership purchases the property or the property is contributed by another partner. In either event, except when the ceiling rule applies, the noncontributing partner will be allocated the same amount of depreciation.

The traditional method can result in some seemingly unfair results because of the "ceiling rule." The ceiling rule states that the amount of income, gain, loss, deduction, or a combination of these that can be allocated to a partner for tax purposes can't exceed 100% of the actual amount of each item that the partnership recognizes for tax purposes. Thus, the partner may not receive tax allocations equal to the economic allocations (profit, loss, etc.) made to that partner. This limitation often fails to eliminate the book-tax differences existing on contributed property. This, in turn, creates a disparity for the noncontributing partners.

EXAMPLE

Problems Created by the Ceiling Rule

Assume the same facts as Example 3, except that Tom and George are 50% partners and George contributes $8,000 in cash when Tom contributes the property. After the contribution, the property depreciates in value from $8,000 to $6,500. The partnership then sells the property for $6,500. The partnership now has a $1,500 economic loss. However, there is still a tax gain of $2,500 ($6,500 – $4,000). Since this is a 50/50 partnership, the $1,500 economic loss ($8,000 – $6,500) is allocated $750 to each partner, which leaves each partner with a capital account of $7,250. It would also make sense to allocate a tax gain of $3,250 to Tom and a tax loss of $750 to George to bring their tax capital accounts equal to their economic (book) capital accounts.

However, the ceiling rule limits the amount of tax gain that can be allocated to the actual amount of the gain, or $2,500. Thus, Tom can only be allocated $2,500 of gain. George is allocated no gain and no loss.

If the partnership is liquidated immediately after the sale and distribution of the proceeds, each partner will receive $7,250 in cash. Since Tom has a tax basis of $6,500, he recognizes a capital gain of $750 on liquidation. Since George's tax basis is $8,000, he will recognize a capital loss of $750 on liquidation.

The Traditional Method with Curative Allocations

Where the ceiling rule has caused distortions, Reg. Section 1.704-3(c)(1) allows the partnership to make reasonable curative allocations of other partnership items. Curative allocations for tax purposes differ from allocations of items for book purposes. Reg. Section 1.704-3(c)(3) provides that a

reasonable curative allocation to the noncontributing partner is limited to the amount necessary to offset that partner's book-tax difference caused by the ceiling rule for the current tax year. A curative allocation of a tax item to the noncontributing partner reduces the allocation of such item to the contributing partner by the same amount. The allocation is strictly a tax allocation and has no impact or effect on any related economic allocations. The allocation must come from other partnership income or expense items. Furthermore, the allocation is reasonable only if the allocation provides the same tax effect (i.e., ordinary) as the tax items affected by the ceiling rule. In addition, a partnership may limit its curative allocations to a particular item or items, even if the allocation of those items doesn't completely offset the impact of the ceiling rule (Reg. Section 1.704-3(c)(1)).

The combined effect of the ceiling rule and the curative allocations is that equal allocations of book and tax items are made to noncontributing partners.

Curative allocations allow the noncontributing partner the current tax benefits of items such as losses that would otherwise be postponed until the liquidation of the partner's interest in the partnership.

Reg. Section 1.704-3(c)(3) provides that to be reasonable, curative allocations must be of the same amount and have substantially the same effect on the partners' tax liability as the items limited by the ceiling rule. Additionally, the curative allocations must be made in the same year in which the ceiling rule limitations occur.

Thus, a limitation on tax depreciation may generally be offset in the same year by a curative allocation of depreciation on another item of partnership property.

There are situations in which the IRS will not allow for the use of curative allocations. Generally, such an allocation will not be allowed when the allocation results in income being shifted to a lower income bracket taxpayer from a high bracket taxpayer.

The Remedial Allocation Method

Reg. Sections 1.704-3(d)(4)(i) and (ii) provide a third reasonable method for accounting for book-tax differences. The traditional method with curative allocations cures ceiling rule distortions only if the partnership has enough tax gain or loss of the appropriate type from another source.

The remedial allocation method allows the partnership to restore its books to good order by creating the tax gain or loss of the appropriate type needed to offset ceiling ruling distortions. Like the traditional method with curative allocations, the remedial method results in tax allocations that have no effect on the partnership's book capital accounts. Furthermore, the remedial allocation isn't dependent upon the actual tax items of income or deductions incurred by the partnership.

Under the remedial method, if the ceiling rule results in a book allocation to a noncontributing partner that differs from the partner's corresponding tax allocation, the partnership may make a remedial allocation to the noncontributing partner equal to the full amount of the disparity and a simultaneous offsetting remedial allocation to the contributing partner. This is an all-or-nothing proposition—the entire allocation must be made.

A remedial allocation must have the same effect on each partner's tax liability as the item limited by the ceiling rule (i.e., if the tax item limited by the ceiling rule is a loss from the sale of a contributed capital asset, the offsetting remedial allocation to the contributing partner must be capital gain).

Effectively, the remedial method assures that ceiling rule distortions are corrected regardless of other income or loss realized by the partnership.

The regulations provide for a special rule regarding depreciable property under the remedial method. In the remedial allocation, the partnership must bifurcate book basis in any depreciable property between the book basis equal to the tax basis in the property at the time it is contributed and the remaining book basis.

The book basis in the property equal to the tax basis is recovered over the remaining recovery period under IRC Section 168(i) (7) (Reg. Section 1.704-3(d) (2)). The original cost portion of the asset is recovered using the method that was in place prior to the contribution. However, any addition created by the remedial allocation is depreciation as if it were a newly acquired asset of the partnership. Such an asset makes use of the life, and method that would have been available to the partnership (Reg. Section 1.704-3(d)(2)).

However, the proposed regulations issued under Section 168(k) to deal with the 100% bonus depreciation rule will not allow the use of Section 168(k) additional first year depreciation on this deemed asset.

When the ceiling rule limits the amount of a tax allocation to the noncontributing partner, the partnership can make a remedial tax allocation (i.e., an additional ordinary deduction) to that partner equal to the limitation caused by the ceiling rule. At the same time, the partnership makes an offsetting remedial allocation (i.e., of ordinary income) to the contributing partner. Because the partnership does not realize these additional amounts of deduction and offsetting income but uses them merely to counteract the ceiling rule, the remedial allocation method effectively repeals the ceiling rule.

In the proposed regulations under Section 168(k) the IRS rules that any such "deemed asset" created by a 704(c) remedial allocation will not be eligible for bonus depreciation.[8] The IRS reasoning, found in the preamble, states:

> Notwithstanding the language of Section 1.704-3(d)(2) that any method available to the partnership for newly purchased property may be used to recover the portion of the partnership's book basis in contributed property that exceeds its adjusted tax basis, remedial allocations do not meet the requirements of Section 168(k)(2)(E)(ii). Because the underlying property is contributed to the partnership in a Section 721 transaction, the partnership's basis in the property is determined by reference to the contributing partner's basis in the property, which violates Sections 179(d)(2)(C) and 168(k)(2)(E)(ii)(II). In addition, the partnership has already had a depreciable interest in the contributed property at the time the remedial allocation is made, which is in violation of Section 168(k)(2)(E)(ii)(I) as well as the original use requirement.

The preamble continues to note that the same rule applies in the case of revaluations of partnership property, otherwise referred to as reverse 704(c) allocations.

While also issuing new proposed regulations on "new provisions not addressed previously," the IRS issued final regulations under Section 168(k) in 2019. The new pronouncement states: "The August Proposed Regulations and these final regulations provide that remedial allocations under Section 704(c) do not qualify for the additional first year depreciation deduction. The same rule applies in the case of revaluations of partnership property (reverse Section 704(c) allocations)."

The same prohibition on the use of bonus depreciation will apply to the zero-basis property rule found at Reg. Section 1.704-19(b)(2)(iv)(g)(3). As the preamble explains:

> Section 1.704-1(b)(2)(iv)(g)(3) provides that, if partnership property has a zero adjusted tax basis, any reasonable method may be used to determine the book depreciation, depletion, or amortization of the property. The proposed regulations provide that the additional first year depreciation deduction under Section 168(k) will not be allowed on property contributed to the partnership with a zero adjusted tax basis because, with the additional first year depreciation deduction, the partners have the potential to shift built-in gain among partners.

These regulations provide that remedial allocations are notational tax items created by the partnership solely for tax purposes and do not affect the partnership's computation of its taxable income.

Additionally, remedial allocations have no effect on the partnership's tax basis in assets or the partners' capital accounts. However, they have the same effect as actual tax items on a partner's tax liability and the partner's outside basis. A remedial allocation is reasonable only to the extent that it is necessary to offset the ceiling rule limitation in any year.

IRS Partnership Audit Technique Guide Examples

The IRS has a series of examples in their Audit Technique Guide for Partnerships that illustrate the application of the Section 704(c) provisions and the various allocation methods. These examples are reproduced as shown in the following examples:

EXAMPLE

Tax & Book Gain

Adam and Melvin form an equal partnership in which Adam contributes raw land with a tax basis of $10,000 and an FMV of $50,000. Melvin 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 value 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 Adam.

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

Consistent with the assignment of income principles, Melvin 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 ($40,000) that accrued prior to contribution is allocated back to the contributing partner.

EXAMPLE

Tax Gain but Book Loss

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 Adam. Melvin, on the other hand, has suffered an economic loss but has no accompanying tax loss. Remember that Melvin bought an undivided interest in a partnership that owned land worth $50,000. The land had a book value 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 Melvin's book (or economic) loss. Melvin has run into the so-called "ceiling rule," which prevents a partnership from allocating items of income, gain, loss, and deduction that exceed 100% of the total amounts of such items that the partnership actually recognizes for tax purposes.

Traditional Method

This method focuses solely on eliminating the contributing partner's built-in gain or loss. Under the facts of the prior example, the noncontributing partner would be forced to wait until the partnership liquidates in order to get a tax loss to match his economic loss. The partners' tax capital and book capital accounts under the traditional amount are as follows:

	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
Total	$30,000	$40,000	$50,000	$40,000

If the partnership distributes its cash of $80,000 in complete liquidation (Melvin'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	
	Tax	Book	Tax	Book
Initial Balance	$10,000	$50,000	$50,000	$50,000
Land Sale	$20,000	–$10,000	0	–$10,000
Total	$30,000	$40,000	$50,000	$40,000

Under the traditional method, the ceiling rule causes Melvin to incur an economic loss that will not be matched by a current tax loss. Instead, the loss will be recognized for tax purposes up disposition of his partnership interest. Melvin is not allocated a tax loss in conjunction with his book loss because the partnership doesn't have a tax loss to allocate to him.

EXAMPLE

Remedial Allocation

In the prior example, Melvin 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 Melvin and a tax gain of $10,000 for Adam.

	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)	
Total	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.

EXAMPLE

Issue: IRC Section 104(c) and Depreciable Property

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

EXAMPLE

Issue: Depreciable Property & the Traditional Method

Assume the same facts as in the preceding example 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.

EXAMPLE

Traditional Method with Curative Allocations

Assume the same facts as in the earlier example, 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)
Adjusted Capital Accounts	40	90	92	90

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.

EXAMPLE

Remedial Allocation Method

Al contributes equipment with an 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 value 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 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 five-year life. The excess ($80) is depreciated as if it was a newly purchased asset. In this example, it is depreciated over a 10-year life.

The annual depreciation deduction for the first five 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.

Additional Section 704(c) Provisions

As noted previously, Reg. Section 1.704-3(d)(3) requires that the partnership allocate an item with the same effect on each partner's tax liability as the tax item limited by the ceiling rule. Where depreciation is the item allocated, the regulations go on to require that the remedial allocation must be "the type produced (directly or indirectly) by the property." Accordingly, it would seem that the allocation must be that of ordinary income.

Reg. Section 1.704-3(a)(2) provides that these methods are applied on a property-by-property basis. A partnership may thus use a different method for each item of Section 704(c) property provided that such method is used consistently for each item of property.

The net result is that depreciation is allocated to the noncontributing partners as if the property had been purchased at its FMV.

Given the opportunity to "game" the system with IRC Section 704(c) allocations, the Treasury issued anti-abuse regulations (Reg. Section 1.704-3(a)(10)). These regulations provide that an allocation method isn't reasonable if the property contribution and the tax allocations are made in a manner that substantially reduces the net present value of the partners' aggregate tax liability. In May 2008, the IRS proposed amendments to the anti-abuse regulations that, when finalized, would require the tax effect of an allocation to consider the impact on both direct and indirect partners. An indirect partner is one owning an interest in any entity owning an interest in the partnership. This amendment broadens the scope of the anti-abuse regulations with respect to the IRC Section 704(c) allocations.

DISTRIBUTIONS OF PROPERTY & SECTION 704

Congress perceived an inconsistency in treatment of partnership sales and partnership distributions of property contributed by partners. Under prior law, recognition of precontribution gain occurred only on the sale of the contributed property.

Effectively, by "bouncing" property through a partnership, a partner could—absent special rules—execute the equivalent of a Section 1031 tax-free exchange of assets that otherwise would not qualify for Section 1031 treatment. That could be because the assets themselves were excluded from this treatment or because the taxpayer would be unable to meet the time requirements imposed on deferred Section 1031 exchanges.

Section 704(c)(1)(B) was enacted to deal with this perceived ability to game the system.

General Section 704(c)(1)(B) Provisions

Effective for property contributed to a partnership after 1997, Section 704(c)(1)(B) provides that pre-contribution gain will generally be recognized on the distribution of the contributed property as well as upon sale. The contributing partner now recognizes gain when property is distributed by the partnership to a partner other than the contributing partner if the distribution occurs less than seven years after the date of contribution.

The amount of gain or loss recognized by the contributing partner equals the amount he would have had to recognize had the property been sold by the partnership on the date of distribution. Both the contributing partner's outside basis and the inside basis of the distributed property are increased (decreased) by the amount of gain (loss) recognized. The character of the recognized gain or loss is the same as if the partnership had sold the property to the distributee at the time of distribution. The

contributing partner's basis in his partnership interest is adjusted to reflect this recognition of gain or loss. The provision does not affect the partnership's ability to adjust basis under a Section 754 election.

EXAMPLE

Application of Section 704(c)(1)(B)

Three years ago, Jim contributed investment land ($50,000 FMV and $32,000 basis) in exchange for a 50% interest in the Jimbo Partnership. Section 721 immunizes Jim from gain recognition at the time of contribution. During the current year, the partnership distributed the land contributed by Jim to his partner, Bo. At the date of distribution, the FMV of the land was $61,000 and Bo's outside basis in his partnership interest was $112,000.

Because the land was distributed to noncontributing partner Bo within seven years of its contribution to the partnership, contributing partner Jim must recognize an $18,000 gain in the current year. If the partnership had sold the land for $61,000, $18,000 of the $29,000 taxable gain recognized would have been specially allocated to Jim. Jim increases his outside basis by $18,000, and the partnership increases its $32,000 pre-distribution inside basis in the land to $50,000.

"Could Have Been a Section 1031 Exchange" Exception

A special provision mirrors the effects of a tax-free exchange under IRC Section 1031. IRC Section 704(c)(2) provides that if property contributed by one partner (the contribution partner) is distributed to another partner (the distributee partner) and within a limited time period like-kind property is distributed to the contributing partner, the contributing partner is considered to have received a distribution of her contributed property.

The provision effectively mitigates against gain recognition from inside the partnership when the same exchange could have been accomplished tax free outside the partnership. The limited time period is the lesser of 180 days from the date of distribution to the distributee partner or the due date (including extensions) of the contributing partner's tax return for the year of the distribution of the substitute property.

The 2017 Tax Cuts and Jobs Act narrowed the scope of tax-free exchanges under Section 1031. While realty may still qualify, personal property no longer qualifies for like-kind exchange treatment. Section 704(c')(2) looks to Section 1031 for its definition of "like-kind."

Other Potentially Applicable Provisions—Disguised Sales

Other transactions are treated as deemed or disguised sales as well under IRC Section 707. This situation arises most frequently where the partner transfers the property and there is a subsequent distribution of property (normally cash) to the partner within two years of the transfer (Reg. Section 1.707- 3(c)(1)). A detailed discussion of these provisions is in the module discussing transactions between partners and partnerships.

CONTRIBUTION OR DISGUISED SALE

A similar problem arises of gain recognition being triggered when a partner contributes property to the partnership and the partnership distributes other property to the contributing partner within seven years—the mechanical "deemed sales" rule (IRC Section 737(b)(1)).

If a partner receives a distribution of property, the FMV of which is in excess of the outside basis in her partnership interest immediately prior to the distribution, the partner must recognize gain equal to the lesser of:

- the excess value over basis or
- the net pre-contribution gain of the partner.

Net pre-contribution gain is the net gain, if any, that would be triggered if all property contributed by the partner to the partnership within the seven-year period prior to distribution had been distributed to a noncontributing partner. The recipient partner's outside basis is increased by the amount of the Section 737 gain. This increase is deemed to occur immediately before distribution. The inside basis of the partner's contributed property is also increased by the amount of gain recognized on the distribution. The character of the gain is determined by reference to the character of the pre-contribution gain.

EXAMPLE

Section 737

Three years ago, Frank contributed investment land ($50,000 FMV and $32,000 basis) in exchange for a 50% interest in the Blowco partnership. Section 721 immunizes Frank from gain recognition at the time of contribution. During the current year, he received a distribution of property with an FMV of $40,000 and an inside basis to the partnership of $25,000. Frank's pre-distribution outside basis in his partnership interest is $13,000. Because the distribution of the property occurred within seven years of Frank's contribution of the land, he must recognize an $18,000 gain, the lesser of the $27,000 excess of the FMV of the property over his outside basis, or his $18,000 net pre-contribution gain.

The partnership increases its $32,000 inside basis in Frank's contributed land by $18,000. Frank increases his outside basis by the $18,000 gain recognized and decreases it by his $25,000 carryover basis in the property.

Frank's pre-contribution	$13,000
Increased by Section gains	$18,000
Decreased by carryover basis of property from partnership	–$25,000
Frank's post-distribution basis in partnership interest	$6,000

The gain-recognition rule of Section 737 is designed to prevent Frank from accomplishing a tax- free exchange of land for other property by making a nontaxable contribution of the land to a partnership and receiving a nontaxable distribution of the property. Accordingly, the gain- recognition rule under Section 737 does not apply to a distribution of property that the recipient partner had originally contributed to the partnership.

CONTRIBUTION OF SERVICES IN EXCHANGE FOR PARTNERSHIP INTEREST

IRC Section 721 provides that "no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." The key word in this provision is *property*. The nonrecognition rule of IRC Section 721 does not apply to partnership interests received for the performance of services.

When services are contributed to a partnership, the tax consequences will depend on the type of partnership interest received and whether or not that interest is restricted in some way. If the service partner receives an unrestricted interest in partnership capital, the FMV of the interest is taxable to the service partner as ordinary income. The partnership deducts or capitalizes the amount based on the type of services rendered. If the service partner receives an interest solely in future partnership profits (as distinguished from an interest in partnership capital), the tax consequences of the transaction are unclear.

Partnership Capital Interest for Services

Tax-free exchange treatment is available only in the case of a partnership interest received in exchange for property. Services rendered are not property that will satisfy the nontaxable exchange provisions. Reg. Section 1.721-1(b)(1) provides:

> [t]o the extent that any of the partners gives up any part of his right to be repaid his contributions *(as distinguished from a share in partnership profits)* in favor of another partner as compensation for services . . . Section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under [IRC] Section 61.

EXAMPLE

Partnership Interest Received for Services

Assume that Bob and Joan form a partnership to acquire and operate rental property. Bob contributes $100,000 for a 50% interest in the capital and profits of the partnership. Joan receives a 50% interest in the capital and profits of the partnership in exchange for her services to manage the property.

If the partnership was liquidated immediately after formation, Joan would realize $50,000 on her capital interest ($100,000 capital × 50%); thus, Bob has given up part of his right to be repaid his capital contribution. He has received a capital interest worth $50,000, which will be taxed as ordinary income.

The capital accounts of the partnership would reflect Bob's $100,000 contribution as follows:

Bob's capital account	$50,000
Joan's capital account	$50,000

The value of Joan's capital interest is included in her gross income under the definition of either IRC Section 61 or IRC Section 83(a). Under Reg. Section 1.61-2(d)(1), if services are paid for in property, the FMV of the property taken in payment must be included in income. If the services are performed at a stipulated price, such price is presumed to be the FMV of the property received in the absence of evidence to the contrary.

Grant of Restricted or Contingent Interest (Section 83)

Instead of an unrestricted capital interest, a service partner may receive a conditional promise of a future capital interest in a partnership or a capital interest subject to substantial risk or forfeiture. For example, a service partner may receive a capital interest in a partnership in exchange for services conditioned on the services continuing for five years. Under IRC Section 83, the receipt of such a restricted capital interest may not result in currently taxable income. Instead, the partnership interest is included in the service partner's income in the taxable year in which the partnership interest becomes freely transferable or not subject to substantial risk of forfeiture—that is, when the partner's rights in the interest are substantially vested. The amount included in the service partner's gross income is the value of the partnership interest at the time the interest first becomes freely transferable or not subject to substantial risk of forfeiture. The value is determined as if the only restrictions on the partnership interest are those which by their terms will never lapse. Under IRC Section 83, partnership interests received in exchange for services are valued and included in income at the same time (i.e., the year in which the interest becomes not subject to substantial risk of forfeiture). The resulting deduction appears (although it is not clear) to be allocated to all partners, including the service partner.

Valuation of Transferred Interest

Where the interest transferred is a capital interest, the value is normally assumed to be the liquidation value; thus, the FMV is the amount a partner providing the services would receive if the partnership was liquidated immediately after the transfer. This liquidation value may reflect the FMV of the interest. However, there is also the opportunity to consider whether a lower value should be used, once appropriate discounts for lack of marketability, liquidity restrictions, and other non-lapsing restrictions are taken into account.

Where the interest is subject to a non-lapsing restriction (i.e., the redemption price of the interest will be twice book value), the FMV for IRC Section 83 purposes will be the value of the interest taking into consideration the restriction. However, if the restriction is later removed by the partnership, additional compensation issues arise (IRC Section 83(d)(2)).

A transfer tax warning is in order on this issue. Using such restrictions for family members generally won't work because IRC Section 2704(b) gives the IRS the authority to disregard any such restrictions where the family controls the partnership immediately before the transfer. Called an "applicable restriction," such a restriction can either be terminated by the family (because of the control) or partially or completely lapses immediately after the transfer. In short, this means that any limitation on family members that is more restrictive than state law won't be effective for tax valuation purposes.

Section 83(b) Election

The partnership interest is considered transferred to the service partner when he receives the interest even though it is subject to substantial risk of forfeiture (Reg. Section 1.83-1(a)(1)). IRC Section 83(b) permits the service partner to elect to include the value of the partnership interest in gross income in the year the interest is transferred instead of in the year in which the restrictions lapse.

If an IRC Section 83(b) election is made, the partnership interest is valued at the time of receipt, only taking into account restrictions that will never lapse. Examples of restrictions that will never lapse are the permanent limitation on the transferability of property, which requires valuation by formula, and the limitations that are enforceable against the transferee.

The election must be made within 30 days after the interest is transferred as prescribed in Reg. Section 1.83-2(c).

The election is not without risk. If the partner elects under IRC Section 83(b) to be taxed currently on the value of the partnership interest, no deduction is allowed if the interest is subsequently forfeited.

Once made, the election can only be revoked with the IRS's consent, which isn't given freely. In fact, in Rev. Proc. 2006-31, the IRS provided the criteria it would use in determining whether there was a mistake of fact in making the Section 83 election. The Rev. Proc. provides that a mistake of fact is an unconscious ignorance of a fact that is material to the transaction. The relief in Rev. Proc. 2006-31 is narrow.

The relief will neither apply where a service provider fails to understand that substantial risk of forfeiture associated with the transferred property is not a mistake of fact under Reg. Section 1.83-2(f), nor will it apply where a service provider fails to understand the tax consequences of making an election under IRC Section 83(b). Simply put, these aren't mistakes of fact under Reg. Section 1.83-2(f).

EXAMPLE

Application of Section 83(b)

Assume that Nat performs services in exchange for a capital interest valued (ignoring restrictions) at $25,000. The agreement states that the interest is forfeited if Nat discontinues his services at any time during the next three years.

Nat may elect under IRC Section 83(b) to recognize the $25,000 currently as ordinary income, or he can include the value of the interest in income in the year the interest is no longer subject to the risk of forfeiture. For example, if Nat estimates the value of the partnership interest at the end of three years to be $45,000, he must decide whether to recognize ordinary income of $25,000 currently or $45,000 three years from now. The amount he recognizes as income becomes his basis in his partnership interest.

If Nat recognizes $25,000 currently but subsequently forfeits his interest, no deduction is allowed to Nat for the $25,000 loss resulting from the forfeiture.

A final comment regarding the IRC Section 83(b) election—if the election is made to recognize income currently, capital gain may be produced by a sale of the partnership interest once restrictions lapse. If no election is made and the value of the interest has appreciated in the interim, the partner will recognize additional ordinary income when the restrictions lapse. With the election, there would not be taxable event on the lapse, and the appreciation would remain untaxed until the partner disposed of her interest.

Income Allocation Status of Partner with Restricted Capital Interest

What is the tax impact on allocations if a taxpayer receives a partnership interest with a substantial risk of forfeiture and no Section 83(b) election exists?

Despite the fact that the partner may hold a specified percentage of interest and be allocated (under the agreement) income based on that interest, that allocation will not be recognized for tax purposes

until or unless the partner actually receives something that can't be forfeited in relation to that allocation.

In the case of *Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15 (2013), a partner who was granted a capital interest that was subject to forfeiture (and eventually was forfeited) was only held to be taxable on his allocation of income to the extent he received distributions (which, under the terms of the agreement, would not have to be repaid if he did not remain with the entity for the specified time).

If the partner in the Crescent Holdings case would have made a Section 83(b) election, then he would have paid tax on his full allocation of partnership income.

Section 409A & Granting of a Restricted Interest for Services

IRC Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all tax years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met. The statute provides that IRC Section 409A can apply to an arrangement between a partner and a partnership (including a member and an LLC) if the arrangement provides for the deferral of compensation under a nonqualified deferred compensation plan.

However, given the nature of IRC Section 409A, it should be limited to IRC Section 707(a) payments and certain IRC Section 707(c) payments. The guaranteed payments covered by IRC Section 409A should only be those amounts for services where the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partnership in which the partner obtained a legally binding right to the guaranteed payment, or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

The consequences of failing to satisfy the requirements of IRC Section 409A are onerous:

- Acceleration of income recognition on the nonqualified deferred compensation
- A penalty equal to 20% of the compensation that is required to be included in gross income
- Interest on the deferred amounts

Notice 2005-1 provides interim guidance on IRC Section 409A consequences of issuing certain interests. If a profits interest issued for services is not treated as currently taxable on issuance, it will not be considered to result in deferred compensation. Similarly, the issuance of a capital interest for services is treated in the same manner as issuance of stock in a corporation. Further, until additional guidance is issued, partners and partnerships can treat the issuance of a capital interest in exchange for services in the same manner as an issuance of stock.

Notice 2005-1 exempts issuance of a profits interest in exchange for services from the provisions of IRC Section 409A, as well as arrangements covered by IRC Section 736, unless the payments fall within the provisions of IRC Section 1402(a)(10) (dealing with payments after all capital has been repaid that continue at least until death), although the IRS is reserving judgment on certain issues until later.

Final regulations issued in April 2007 made Notice 2005-1 obsolete except as it applied to very limited circumstances, including (importantly for this course) partnership and partner arrangements

described earlier in this section. It isn't clear when the IRS or Treasury will provide additional guidance in the partnership area.

Impact on the Partnership & Other Partners

The transfer of a partnership capital interest in exchange for services performed for the partnership is treated as an IRC Section 707(c) guaranteed payment (Reg. Section 1.721-1(b)(2)). Whether or not the guaranteed payment is deductible by the partnership depends on the nature of the services performed (guaranteed payments are discussed later in this course).

Because the transfer of a partnership capital interest is an IRC Section 707(c) guaranteed payment, the transaction should be viewed as two related transactions.

- The transfer of an undivided interest in partnership assets to the service partner is an IRC Section 707(c) transaction. The service partner would recognize as income the value of assets deemed distributed to him. The partnership's treatment of the guaranteed payment will depend on the nature of the services performed (it may be an ordinary deduction, require to be capitalized, or be a nondeductible capital item). The difference in the FMV of the interest and the basis of the transferred assets results in taxable gain to the partnership.

- A contribution by the service partner of the undivided interest in partnership assets is in exchange for a partnership interest. This deemed contribution is treated as an IRC Section 721 exchange in which no gain or loss is recognized.

As a result of the hypothetical transfer of assets to the service partner in an IRC Section 707(c) transaction, the partnership, in effect, has satisfied an obligation with property. Thus, the partnership should recognize gain or loss equal to the difference between its basis and the value of the undivided interest in assets transferred to the service partner (Rev. Rul. 2007-40). The service partner has a basis in the assets equal to the value of the assets—that is, a basis equal to the amount the service partner reported as ordinary income. The service partner's basis in the assets becomes the partnership's basis upon the deemed contribution of the assets back to the partnership.

The next example illustrates the tax consequences of the transfer of a partnership capital interest in exchange for services.

EXAMPLE

Services Contributed to a Partnership

Assume that the only asset of the High Sierra Partnership is an apartment building with an adjusted basis of $100,000 and an FMV of $500,000. The partnership has no liabilities. In return for management services, High Sierra transfers an unrestricted 25% capital interest to Felicity.

The transaction should be viewed as a transfer by High Sierra to Felicity of a 25% interest in the partnership's apartment building, followed by a contribution of that property back to the partnership by Felicity pursuant to IRC Section 721. The partnership is treated as having made a guaranteed payment to Felicity in the amount of $125,000 (25% of the $500,000 FMV). Thus, she would report $125,000 as ordinary income and would have a basis in the property of $125,000. If the services represent deductible expenses, the partnership would be allowed a deduction of $125,000 for the guaranteed payment.

The partnership would recognize gain of $100,000 (25% of the $500,000 FMV, less 25% of the $100,000 basis) on the transfer to Felicity. The character of the gain would be determined at the partnership level and, in this case, would be an IRC Section 1231 gain, assuming no depreciation recapture.

Upon the deemed contribution of the property back to the partnership by Felicity, the partnership would have a new basis of $125,000 for the 25% of the property deemed contributed by Felicity. The partnership's basis for its property would be increased to $200,000 as follows:

75% of old basis	$75,000
Felicity 25% interest	$125,000
New basis	$200,000

Note that in the example, the amount of gain recognized by the partnership ($100,000) equals the increase in the basis of the partnership property. The gain should be allocated to the old partners. Any deduction arising from the guaranteed payment also should be allocated to the old partners. To be certain of these results, the allocations should be included in the partnership agreement. The partnership agreement also should provide that the gain on the remaining 75% of the property that is attributable to appreciation prior to the admission of Felicity be allocated to the old partners.

If the service partner receives a capital interest for services rendered to an existing partner rather than to the partnership itself, the transferor partner would recognize gain or loss on the payment of an obligation with property. In addition, the transferor partner, not the partnership, would be entitled to a deduction on his own tax return equal to the value of the partnership interest transferred if the services represent deductible expenses (Reg. Section 1.721-1(b)(2) and IRC Section 162(a)).

The service partner would include the value of the partnership interest in income, just as if that interest had come from the partnership, and would have a basis in the partnership interest equal to its value. Since the partnership is not treated as a party to the transaction, the partnership's basis in its assets would not be affected. The service partner's basis in his partnership interest may be significantly different from his share of the partnership's basis in its assets. In such a case, the service partner may benefit from an IRC Section 754 election to adjust the basis of partnership assets.

When appreciated property is contributed to the partnership by one partner and the other partner contributes other property, the regulations of 1.704-3(a)(1) mandate some type of allocation of the depreciation expense to the partner who did not contribute the appreciated property. As you recall from the previous pages, that allocation may be by any reasonable method. However, three methods are most common. Under the traditional method, Felicity would receive 100% of the depreciation on the building until she receives depreciation equal to 25% (his ownership interest) on a building with a basis of $500,000. Whatever depreciation is not allocated to her will be allocated to the others by their partnership profit and loss percentages compared to each other.

Partnership Profits Interest for Service

While it is clear that a service partner has taxable income equal to the value of a partnership capital interest received for services, the tax treatment of a transfer to a service partner of an interest in only the profits of the partnership (a profits interest) for services has only recently required some clarification.

Initially, it seemed simple—a taxpayer who received a profits interest only for services would not have income at that point in time. However, a mortgage broker (Sol Diamond) with a short-term capital loss that would go unused managed to complicate matters.

Sol Diamond was given a 60% profits interest in a partnership for his services in securing financing for a project. However, first the other partner (who advanced the down payment) had to be repaid, so the property had to appreciate just under $80,000 before Sol would receive any funds. The other partner had been associated with Sol in various ventures over 24 years.

Three weeks after the closing, Sol sold his profits interest back to his associate for $40,000. Sol, who had a capital loss that would nicely offset this income if it was a capital gain, reported the transaction as a sale of the interest for $40,000, entirely offset by the capital loss that otherwise was going to go unused in that tax year. Sol had effectively taken $40,000 of income realized due to the services he performed, which normally could not be offset by that capital loss, and magically (he thought) transformed it into income that could be offset.

The Tax Court, sustained by the Seventh Circuit on appeal, decided that while normally a profits interest does not have an easily determined FMV, Sol had graciously provided one—and the regulations did not say that receipt of the interest was not taxable. Thus, the court found Sol had $40,000 of ordinary income when he received the interest. (*Sol Diamond v. Commissioner*, 56 T.C. 530, affd. CA7 1974 33 AFTR 2d 74-852)

Unfortunately, that "bad facts" decision left open the question of what happens in cases that aren't quite as clear as Sol's. But it was clear that the courts did not accept the blanket rule that no income is recognized on receipt of a profits interest.

Neither the code nor the regulations specifically define a profit interest in a partnership. Reg. Section 1.721-1(b)(1) seems to indicate that a profit interest is one that does not entitle the partner to share in the partnership assets upon liquidation of a partnership interest. As the following example indicates, this regulation must be interpreted to mean, "other than in those assets that are, or are acquired with, partnership earnings realized after the partner received his profits interest."

EXAMPLE

Profits Interest for Services

Assume Mark and Sally form a partnership. Mark contributes land with basis and FMV of $100. Sally contributes future services. Mark's capital account is credited for $100; Sally's capital account is zero. After two years, the land is sold for $200, again with a basis of $100. Mark and Sally would each be allocated $50 of gain. Mark's capital account is now $150 and Sally's is $50. Upon liquidation of the partnership at this point, Sally would indeed receive $50, which is her share of partnership assets.

Section 1.721-1(b)(1) distinguishes transactions in which a partner "gives up any part of his right to be repaid his contributions" from transactions in which a partner gives up "a share in partnership profits" in favor of another partner as compensation for services. Reg. Section 1.704-1(e)(1)(v) defines a capital interest as "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." This section of the regulations goes on to state that the mere right to participate in the earnings and profits of the partnership is not a capital interest.

When read in conjunction with Reg. Section 1.721-1(b)(1), the receipt of a capital interest seems clearly to refer to the right of a service partner to receive some portion of another partner's capital account upon liquidation or the right to share in pre-admission appreciation. The right to share only in post-admission appreciation is a profit interest.

For purposes of the following discussion, the approach suggested by these two sections of the regulations is adopted. A profits interest is one that would not entitle the holder to receive assets (other than assets represented by post-admission income) upon a liquidation of the partnership immediately following the acquisition of the interest, but it does give the holder the right to share in future profits of the partnership.

EXAMPLE

Profits Interest vs. Capital Interest

Assume that Bart and Lisa form a partnership. Bart contributes cash of $100,000 and has an initial capital account of $100,000. Lisa contributes nothing but is to manage the partnership business. Lisa's initial capital account is zero. The partners agree to share equally in partnership profits and losses.

Upon immediate liquidation of the partnership, the $100,000 in cash would be distributed to Bart in satisfaction of his capital account and Lisa would receive nothing. Thus, Lisa does not have a capital interest, but only a profits interest.

The code does not address the tax treatment of a partner who receives only a profit interest for services. The regulations clearly distinguish between a partnership capital interest and a partnership profits interest. Reg. Section 1.721-1(b)(1) provides:

> [t]o the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), [IRC] Section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under [IRC] Section 61. (Emphasis added.)

The regulations unequivocally state that a partnership capital interest received as compensation for services is income to the service partner. Unless the parenthetical provision "(as distinguished from a share in partnership profits)" was meant to indicate a different treatment for the receipt of a partnership profits interest, the provision has no meaning.

Furthermore, the parenthetical provision was not in the proposed regulation but was added when the regulation was finalized. The addition of the parenthetical provision seems to have reflected an intentional decision not to treat the receipt of a profit interest as a taxable event.

In Rev. Proc. 93-27, the IRS finally ruled that the receipt of a partnership profits interest for services provided to or for the benefit of the partnership was not taxable except under very limited circumstances. The circumstances excluded from the revenue ruling, and thus presumably those under which the receipt of a profit interest is taxable, are:

- if the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from a high-quality debt security or a high-quality net lease;

- if within two years of receipt, the partner disposes of the profits interest; or
- if the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b) of the Internal Revenue Code.

The determination of whether the interest in the partnership is a profits interest is tested at the time the interest is granted, even if substantially nonvested. It should be noted that neither the partnership nor the partner may deduct the FMV of the interest (Rev. Proc. 2001-43).

Impact on Partnership & Other Partners, Assuming That the Receipt of the Profits Interest Is Taxable

Like the transfer of a partnership capital interest, the transfer of a partnership profits interest in exchange for services is treated as an IRC Section 707(c) guaranteed payment if the transfer of the interest meets one of the three conditions under Rev. Proc. 93-27. The tax consequences of a transfer of such profits' interest basically are the same as the tax consequences of a transfer of a capital interest.

The tax treatment of the transfer of a partnership profits interest under these circumstances can be summarized as follows.

- A service partner who receives a profits interest realizes compensation income equal to the value of the interest received under IRC Section 83.
- The service partner's basis in his profits interest is the same as the amount of compensation income he realizes.
- The partnership is entitled either to a current deduction or will capitalize the amount of the guaranteed payment, depending on the nature of the services performed.
- The partnership is treated as assigning a portion of its future income to the service partner in an IRC Section 707(c) guaranteed payment. This anticipatory assignment of income causes the partnership to immediately recognize the value of the assignment as income.
- The service partner is treated as immediately contributing the interest in future partnership income back to the partnership in exchange for a partnership profits interest. The service partner has a basis in the interest in future income, which carries over to the partnership. As the future income is realized by the partnership, the partnership should be allowed to amortize the basis of the income interest acquired from the service partner.

Rev. Proc. 2001-43 clarifies Rev. Proc. 93-27 that the determination of whether a partnership interest is a profits-only interest is tested when the interest is granted, even if substantially nonvested.

The following example illustrates the tax consequences of a transfer of a partnership profits interest for services:

EXAMPLE

Profits Interest Treatment

Assume that the only asset of the Churner Partnership is a bond with an FMV of $100,000. The bond generates interest income of $8,000 per year. The partnership has a remaining fixed term of five years. In return for services, Cory receives a 10% interest in future partnership profits, which entitles him to receive $800 per year (10% of $8,000) for five years. These circumstances meet Condition #1 in Rev. Proc. 93-27 that the profit interest relates to a high-quality debt security.

As a result of the transaction, Cory would report ordinary income equal to the present value of the right to receive $800 per year for five years. Assume that the present value of his right is $3,000. Thus, Cory would recognize $3,000 as compensation income and would have a basis in the right to future income of $3,000. If the services represent deductible expenses, the partnership would be allowed a deduction of $3,000. Upon the anticipatory assignment of a 10% interest in future income to Cory, the partnership must recognize as income the $3,000 value of the assigned income interest. Upon the deemed contribution by Cory of the income interest back to the partnership, the partnership succeeds to his basis of $3,000 in future income. The partnership should be allowed to amortize this basis over the five-year term of Cory's interest.

NOTES

Unit

4

Partnership Distributions

LEARNING OBJECTIVES

- **Distinguish** between current and liquidating distributions.
- **Distinguish** between proportionate and disproportionate distributions.
- **Determine** when gain or loss is recognized.
- **Calculate** the amount of recognized gain or loss.
- **Determine** the effect to a partner resulting from a reduction of partnership liabilities.
- **Determine** the basis in the hands of the distributee partner of distributed property.
- **Determine** the character of gain or loss on the disposition of distributed property.

INTRODUCTION

Distributions of partnership assets are classified as either current distributions or liquidating distributions. Distributions are current when the partners receiving the distributions retain all or part of their partnership interest (IRC Section 761(d)). Even if a distribution reduces a partner's interest from 50% to 1%, it still would be a current distribution. Distributions are liquidating distributions only when a partner's entire interest in the partnership is completely liquidated.

Partnership distributions can be further divided into distributions that do not change the partners' proportionate interests in the hot assets of the partnership and distributions that do change the partners' proportionate interests in the hot assets of the partnership (disproportionate). "Hot assets" or "Section 751 assets" include unrealized receivables and appreciated inventory items (IRC Section 751(b)).

The partnership distribution can consist of cash, property, or a combination of both cash and property. Under IRC Section 752(b), all decreases in a partner's share of partnership liabilities are treated as distributions of cash to the partner from the partnership. The reduction in partnership liabilities can result from a number of transactions, including the regular payment of principal or a payoff of a debt.

A constructive cash distribution triggered by Section 752(b) is equivalent in all respects to an actual distribution of cash. Thus, gain can be recognized by partners upon the payment of a partnership liability.

EXAMPLE

Debt Repayment Creates Income

Billie and Christie form the Duet Partnership. Their basis in the partnership is as follows:

	Billy	Christie
Tax Basis Capital	–$25,000	$5,000
Liabilities	$40,000	$40,000
Basis in Partnership	$15,000	$45,000

The partnership pays off the $80,000 liability. Since the payment of the liability is treated as a distribution of cash, both Billy and Christie are treated as receiving $40,000 in cash. Since Billy's basis is only $15,000, he has $25,000 of income. Christie, who has $45,000 in basis, has no income, but her basis is reduced to $5,000.

For purposes of determining gain or loss on partnership distributions, all of a single partner's partnership interests (i.e., general and limited) are aggregated into a single interest. This follows the rules of capital account maintenance under IRC Section 704(b) (Reg. Section 1.704-1(b)(2)(iv)(b)).

Neither gain nor loss is recognized by the partnership (as opposed to individual partners) on the distribution of property, including money, from the partnership (IRC Section 731(b)).

CURRENT DISTRIBUTIONS: PROPORTIONATE

A current distribution is a distribution that does not liquidate a partner's entire interest in the partnership and is not part of a series of distributions intended to liquidate the partner's interest.

Generally, a current distribution of cash or property is not taxable to the recipient partner if that partner has sufficient basis in his partnership interest. Under Section 731(a), the recipient partner never recognizes a loss as a result of a current distribution. The recipient partner recognizes gain only to the extent that cash distributed to him exceeds the basis of his partnership interest immediately before the distribution. Any gain arising from the current distribution is a capital gain (Reg. Section 1.731-1(a)(3)).

Gain is not recognized by the recipient partner if property other than money is distributed, regardless of the value of the distributed property in relation to the partner's basis of his partnership interest. No gain would be recognized by a partner on the distribution of property (other than money) valued at $10,000, even though her basis in her partnership interest was only $6,000 (IRC Section 731(a)).

In determining whether cash distributions exceed a partner's basis, all advances and drawings against a partner's distributive share are deemed to be current distributions made on the last day of the partnership's taxable year (Reg. Section 1.731-1(a)(1)(ii)). It is not necessary to determine a partner's basis or to determine gain recognition as each distribution occurs. Instead, a partner's distributions are accumulated during the year and offset against his opening capital account, his share of current year profits, any year-end capital contributions, and his share of increases in partnership liabilities. All deemed distributions because of a decrease in liabilities are treated as draws or advances, thus

postponing any determination of gain until year-end. There is a requirement that the draws or advances be repaid if they ultimately exceed the partner's allocable share of income (Rev. Rul. 84-241). However, if a distribution isn't a draw or advance, then the gain or loss on the distribution is measured as of the date of distribution.

PLANNING TIP

Where a partnership believes that its partners may recognize income from a current distribution, the partnership agreement should be amended to specify that all distributions are draws or advances and must be repaid to the extent that those distributions ultimately exceed the partner's distributive share of partnership income.

Additionally, for purposes of determining whether a distribution is in excess of a partner's basis, a distribution of marketable securities is treated as a distribution of cash (IRC Section 731(c) (1)). The value of the marketable securities is their fair market value (FMV) at the date of distribution. The amount of gain that is recognized in a distribution of marketable securities is reduced (but not below zero) by the excess of:

> the partner's distributive share of the net gain that would have been recognized if all of the partnership's marketable securities of the same class and issuer as the distributed securities were sold at FMV immediately before the transaction to which the distribution relates, over the partner's distributive share of the net gain attributable to the marketable securities held by the partnership assuming sale immediately after the transaction using FMV (IRC Section 731(c)(3)(B)).

EXAMPLE

Nonliquidating Distributions

Mark and Boris share equally in the profits of the Wildlife Partnership. On January 1, 2016, Mark's basis in his partnership was $30,000 and Boris's basis was $5,000.

Each partner received a partnership distribution of $20,000 cash on July 11, 2016. Partnership taxable income for 2016 was $24,000. Neither of the partners made any contributions to the partnership during 2016 and their share of partnership liabilities did not change during the year.

Under these facts, the basis of each partner's partnership interest is computed at December 31, 2016, as follows:

	Mark	Boris
Basis at January 1	$30,000	$5,000
Distributive share of partnership ordinary income (50% of $24,000)	$12,000	$12,000
Partnership distribution during 2016	–$20,000	–$20,000
Tentative basis of each partner's interest at December 31	$22,000	–$3,000

In this example, Boris must recognize gain of $3,000 on the distribution. The basis of his partnership interest is zero. A partner's basis cannot be reduced below zero (IRC Section 705(b)). Boris could have avoided the $3,000 taxable gain from excess distributions if he had contributed $3,000 to the partnership by December 31, 2016. The determination of the partner's basis in his partnership interest is typically made at the end of the partnership taxable year. In determining the amount of gain to be recognized by Boris, current

distributions were offset against Boris's beginning basis and his share of current partnership income regardless of distribution dates.

Draws & Income

The recipient partner does not recognize gain on the distribution of noncash assets as long as the distribution does not alter the partners' proportionate interest in IRC Section 751 assets. This is the case regardless of the value of the distributed property in relation to the recipient partner's basis in his partnership interest.

The recipient partner's basis for property received in a current distribution is generally the same as the basis of the property in the hands of the partnership (i.e., the partnership's basis in the property generally carries over to the recipient partner) (IRC Section 732 (a)).

EXAMPLE

Nonliquidating Distribution of Property

Assume that the basis of Craig's partnership interest is $11,000. Property with an adjusted basis to the partnership of $3,000 is distributed to Craig by the partnership. The partnership's adjusted basis of $3,000 carries over and becomes Craig's basis for property.

In the case of a current distribution, the recipient partner's basis in his partnership interest is reduced (but not below zero) by the amount of cash distributed and the basis of distributed property in the hands of the recipient partner (IRC Section 733). In this example, Craig's basis in his partnership interest of $11,000 is reduced by $3,000 since that is his basis for the distributed property. The remaining basis for his partnership interest is $8,000.

The general carryover-basis rule of Section 732(a) is limited when the recipient partner's basis in his partnership interest is less than the partnership's adjusted basis for the distributed property in a current distribution (IRC Section 732(a)(2)). In such a case, the recipient partner's basis for the distributed property is limited to his basis for his partnership interest, reduced by any cash distributed to him. This event leaves the distributee partner with a zero basis in his partnership interest.

EXAMPLE

Nonliquidating Distribution of Cash and Property

Assume that a partner, whose basis in his partnership interest is $4,000, receives a distribution of $3,000 in cash and property with a basis of $5,000 to the partnership. The recipient partner has insufficient basis for the general carryover rule to apply. The $3,000 cash distributed to the partner reduces the basis in his partnership interest from $4,000 to $1,000. The partner's basis for the property distributed is limited to $1,000 (his remaining basis in his partnership interest), even though the partnership's basis in the property was $5,000.

The partner's basis in his partnership interest is reduced to zero ($4,000 original basis less $3,000 cash and $1,000 basis of distributed property).

If more than one item of property is distributed and the limitation of Section 732(a)(2) is applicable, the transferee partner's basis in the distributed assets must be allocated among the distributed assets. The partner's basis in his partnership interest is allocated among the distributed assets as follows (IRC Section 732(c)).

- The partner's basis in his partnership interest is first reduced by the amount of any cash received.
- The partner's remaining basis in his partnership interest is then allocated to unrealized receivables and inventory items up to the amount of the basis of those assets in the hands of the partnership. If the partner's remaining basis of the partnership interest is less than the partnership's combined basis of those assets, the basis of the partnership interest is allocated among the unrealized receivables and inventory items in proportion to the partnership's basis of the assets. In this case, any other property distributed takes a basis of zero. In no case, however, can the basis be reduced below zero.

Bonus Depreciation on Assets Received in Distribution

When the Tax Cuts and Jobs Act modified the rules on bonus depreciation under Section 168(k) to allow for the additional deduction on used property, the IRS had to address the issue of whether property distributed by a partnership to a partner would be eligible for bonus depreciation in the hands of the partner.

Generally, property distributed by a partnership to a partner ends up with a carryover basis, as the IRS explains in the preamble:

> Section 732(a)(1) provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership immediately before the distribution. Section 732(a)(2) provides that the basis determined under Section 732(a)(1) shall not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

In this situation, the proposed regulations under IRC Section 168(k) provide that this property will not be eligible for bonus depreciation treatment when received by the partner.[56] As the preamble continues:

> Property distributed by a partnership to a partner fails to satisfy the original use requirement because the partnership used the property prior to the distribution. Distributed property also fails to satisfy the acquisition requirements of Section 168(k)(2)(E)(ii)(II). Any portion of basis determined by Section 732(a)(1) fails to satisfy Section 179(d)(2)(C) because it is determined by reference to the partnership's basis in the distributed property. Similarly, any portion of basis determined by Section 732(a)(2) or (b) fails to satisfy Section 179(d)(3) because it is determined by reference to the distributee partner's basis in its partnership interest (reduced by any money distributed in the same transaction).

[56] Proposed Reg. Section 1.168(k)-2(b)(3)(iv)(B)

This position was continued in the final regulations. See IR-2019-156, September 13, 2019, https://www.irs.gov/newsroom/treasury-irs-release-final-and-proposed-regulations-on-new-100-depreciation.

REMAINING BASIS OF PARTNERSHIP INTEREST

Any remaining basis of the partnership interest that is not applied to unrealized receivables and inventory items is allocated among other distributed assets based upon relative FMV of the assets except in the case of a liquidating distribution or a nonliquidating distribution where the carryover basis of the property in the distribution exceeds the basis in the partnership interest.

In that case, the additional property's basis is determined by assigning the asset's basis to the extent of any increase or decrease necessary to reflect the remaining basis of the partnership interest. This is accomplished by increasing those assets with unrealized gain or decreasing those with unrealized loss. This is based upon the pro rata basis considering relative unrealized gain or loss.

Any additional amount is allocated based upon relative FMV in the case of gain or relative basis in the case of loss.

These allocation rules are illustrated in the following example.

EXAMPLE

Nonliquidating Distribution

Kara, with an adjusted basis of $15,000 for her partnership interest, receives the following assets in a current distribution:

	Basis	FMV
Cash	$5,000	$5,000
Inventory		$15,000
Blackacre (real property)	$6,000	$8,000
Whiteacre (real property)	$2,000	$4,000
Total	$19,000	$32,000

The $5,000 cash distribution reduces the basis for Kara's partnership interest from $15,000 to $10,000. This remaining basis first is allocated to the inventory. Since the partnership's basis in the inventory of $6,000 is less than the $10,000 remaining balance for Kara's partnership interest, the inventory receives a carryover basis of $6,000. Kara's basis in her partnership interest is reduced to $4,000 ($10,000 minus the $6,000 allocated to the inventory).

This remaining $4,000 basis is allocated between Blackacre and Whiteacre in proportion to their respective FMVs in the hands of the partnership as follows:

	Fair Market Value	Ratio	Allocation of Remaining Basis
Blackacre	$8,000	2/3	$2,667
Whiteacre	$4,000	1/3	$1,333
Total	$12,000	100%	$4,000

Kara's basis in her partnership interest is reduced to zero. In summary:

Kara's basis in her partnership interest before the distribution	$15,000
Less cash distribution	–5,000
Remaining basis allocable to property	10,000
Less basis to partner of inventory distributed (carryover basis)	–6,000
Remaining basis allocable to other property	4,000
Less basis to partner of other property distributed	–4,000
Kara's remaining basis in partnership interest	$0

When a partner receives a distribution of property subject to liabilities, the treatment is similar to that used when a partner contributes property subject to liabilities, except in reverse. The treatment of liabilities in connection with property contributions was discussed in an earlier chapter.

When a partnership distributes property subject to liabilities to a partner, all partners' bases are affected. All partners are treated as if they received a cash distribution equal to their share of the decrease in partnership liabilities and must reduce the bases of their partnership interests by that amount (IRC Section 752(b)).

Accordingly, a partner may recognize income on the distribution of property to another partner encumbered by a liability if the reduction in that partner's share of liabilities reduces the partner's basis below zero, thus triggering gain. The partner assuming the debt is treated as if she made a contribution to the partnership equal to the debt assumed and increases her basis in her partnership interest by that amount (IRC Section 752(a)). The recipient partner also reduces her basis for the property received.

EXAMPLE

Distribution of Property Subject to Liabilities

Assume that Bob, a 20% partner, receives a current distribution of property with a basis of $12,000, subject to a liability of $4,000. Bob's basis in his partnership interest before the distribution is $10,000.

The basis of Bob's partnership interest after the distribution is computed is as follows:

Bob's basis in his partnership before the distribution	$10,000
Plus increase in Bob's individual liabilities resulting from "assumption" of partnership liabilities	4,000
Less basis of property distributed	–12,000
Less decrease in Bob's share of partnership liabilities	–800
Bob's basis in his partnership interest after the distribution	$1,200

The other partners' bases in their partnership interests are decreased by their shares of the $4,000 liabilities, or $3,200.

DISGUISED SALES

Congress addressed transactions that in form were contribution/distribution transactions but in substance were indistinguishable from sales. For example, partners could contribute property to a partnership in a tax-free exchange for a partnership interest. At some future date, the partnership would make a cash distribution to the contributing partner. If the transactions are collapsed, they could be viewed as one transaction in which the partner sold the property to the partnership.

IRC Section 707(a)(2)(B) treats these transactions consistently with their underlying substance.

LIQUIDATING DISTRIBUTIONS: PROPORTIONATE

A liquidating distribution is a distribution that liquidates a partner's entire interest in the partnership or is part of a series of distributions intended to liquidate the partner's interest (IRC Section 761(d) and Reg. Section 1.731-1(a)(2)). Liquidating distributions that do not alter the partner's proportionate interest in IRC Section 751 assets are generally tax free to both the recipient partner and the partnership.

As in the case of a current distribution, the partner whose interest is completely liquidated recognizes gain only if the money distributed to him exceeds the basis of his partnership interest (Reg. Section 1.731-1(a)(1)(i)).

In contrast to the recognition rule for losses on current distributions, losses may be recognized on certain liquidating distributions. A loss may be recognized upon complete liquidation of a partner's interest only if money, unrealized receivables, and inventory are distributed. The loss, if any, would be the excess of the recipient partner's basis in his partnership interest over the sum of any money distributed and the partnership's basis for the unrealized receivables and inventory distributed. If the partner whose interest is liquidated receives any property other than money, unrealized receivables, or inventory, no loss will be recognized (IRC Section 731(a)(2)).

EXAMPLE

Liquidating Distribution

Assume that a partner, whose basis for her partnership interest is $10,000, retires from the partnership receiving $5,000 in cash and property with a basis to the partnership of $3,000.

If the property distributed to the partner includes only inventory items, a loss of $2,000 will be recognized by the partner ($10,000 basis less $5,000 cash and $3,000 property basis).

In contrast, if the property distributed to the partner is unimproved real property, the partner will recognize no loss because she received property other than money, unrealized receivables, and inventory.

Depending on the facts, these rules may permit a partner to recognize a taxable loss even though the partner has an economic gain on the transaction (i.e., where the market value of the distributed assets exceeds the basis of his partnership interest).

EXAMPLE

Liquidating Distribution

Assume that Larry has a basis in his partnership interest of $10,000. In complete liquidation of that interest, Larry receives $5,000 cash and his proportionate share of partnership inventory, which has a basis to the partnership of $3,000 and an FMV of $6,000. Larry receives total consideration for his interest ($11,000 FMV), which exceeds his basis by $1,000.

However, Larry recognizes a loss of $2,000 on the distribution, computed as follows:

Larry's basis in his partnership interest	$10,000
Cash	–5,000
Basis in inventory	–3,000
Recognized loss	$2,000

The basis of the inventory in Larry's hands is $3,000. Upon the subsequent sale of the inventory for $6,000, Larry will recognize $3,000 of income. Thus, in the aggregate, Larry will have a $2,000 capital loss and $3,000 of ordinary income as a result of the distribution and subsequent sale of the distributed inventory.

If a partner's interest is liquidated in a series of distributions that are intended to liquidate his entire partnership interest, all of the distributions are treated as liquidating distributions (Reg. Section 1.761-1(d)). Under the general rule, cash distributions reduce basis. Only after the partner's basis has been reduced to zero do further cash distributions result in taxable gain. If the liquidation of the interest results in a loss and only money, unrealized receivables, and inventory are distributed, the loss is recognized when the liquidation is complete and the partner's entire interest in the partnership is terminated.

Under Section 732(b), the recipient partner's basis for property distributed to him in liquidation of his partnership interest is equal to the partner's basis in his partnership interest immediately before the distribution, reduced by any cash received. Under Section 732(c), if the partner's basis in his partnership interest (reduced for any cash received) is less than or equal to the partnership's basis in unrealized receivables and inventory distributed, the basis is entirely allocated to these assets in proportion to their basis in the hands of the partnership.

On the other hand, if the partner's basis in his partnership interest (reduced for any cash received) exceeds the partnership's basis in unrealized receivables and inventory distributed, these assets are allocated basis equal to their basis in the hands of the partnership. The remaining basis of the partner's interest is allocated to other distributed assets in proportion to each asset's basis to the partnership.

Mechanically, these allocation rules are the same as those applicable to current distributions when the partnership's basis for the distributed property exceeds the recipient partner's basis for his partnership interest. However, in the case of a liquidating distribution, the effect of these rules may be to give the partner a basis in the distributed property (other than unrealized receivables and inventory) that is greater than the partnership's basis for the same assets.

EXAMPLE

Liquidating Distributions

Assume that Sara, who has a basis of $5,000 in her partnership interest, receives a distribution of property (other than unrealized receivables or inventory) having a basis of $2,000 in the partnership.

If the distribution is a current distribution, the carryover basis rule applies: the property takes a carryover basis of $2,000 to Sara and the basis of her partnership interest is reduced to $3,000 ($5,000 original basis less $2,000 property distribution).

If the distribution is a liquidating distribution, Sara's entire basis for her partnership interest of

$5,000 is allocated to the property distributed. Note that where unrealized receivables or inventory are distributed, the basis assigned to such assets cannot exceed the partnership's basis for the assets. When a partnership distributes property subject to liabilities to a partner in a liquidating distribution, the debt received increases the recipient partner's basis of the property distributed.

EXAMPLE

Liquidating Distributions

Assume that Laura, a 20% partner, receives a liquidating distribution of property (other than unrealized receivables or inventory) with a basis of $12,000 subject to a liability of $4,000. Laura's basis in her partnership interest before the distribution is $10,000.

Since this is a liquidating distribution, her basis in her partnership interest after the distribution is zero. Laura's basis in the property is computed as follows:

Laura's basis in her partnership interest	$10,000
Plus: Laura's increase in individual liabilities	4,000
Less: decrease in Laura's share of partnership liabilities (20% of $4,000)	–800
Laura's basis for distributed property	$13,200

Compare this result with Example 6 in the previous section of this module where the facts are the same except they are for a current distribution. In that case, Bob's basis in the property was $12,000 and his basis in his partnership interest after the distribution was $1,200.

HOLDING PERIOD OF DISTRIBUTED PROPERTY

In determining the holding period of assets received in a distribution from the partnership, Section 735(b) generally permits the partner to include the partnership's holding period in his holding period. This tacking rule applies both to property received in a current distribution and to property received in a liquidating distribution. If a partner has contributed the property to the partnership, then the

period that the property was held by the contributing partner will be included in the recipient partner's holding period for the property (Reg. Section 1.735-1(b)).

CHARACTER OF GAIN OR LOSS ON SALE OF DISTRIBUTED PROPERTY

If a partner could change ordinary income assets into capital gain assets by withdrawing them from a partnership, the partnership form could be used as a vehicle for tax avoidance. To prevent this, Section 735(a) provides that certain ordinary income assets retain their character in the partner's hands after distribution. IRC Section 735(a) is designed to prevent abuse through the distribution of unrealized receivables or inventory items by partnership.

Under Section 735(a)(1), distributed unrealized receivables retain their ordinary income character in the hands of the recipient partner. Whenever the partner disposes of these assets received from a partnership, the gain or loss on the disposition is ordinary income or ordinary loss.

Under Section 735(a)(2), distributed inventory items retain their ordinary income character in the hands of the recipient partner for five years. This rule applies to inventory items regardless of whether or not they have appreciated in value. If the recipient partner sells the inventory items within five years after the date of the distribution, the gain or loss on the sale will be ordinary income or ordinary loss. If the sale of the inventory items by the recipient partner occurs more than five years after the date of the distribution, the character of the gain or loss is determined by reference to the character of the asset in the hands of the partner. Capital gain or loss will be realized if the asset is then a capital asset in the hands of the partner.

Those two provisions duplicate the treatment at the partnership level for assets received from a partner found at IRC Section 724, so it doesn't matter if assets are being put into or being taken from the partnership by a partner. However, there is nothing equivalent to the "built-in capital loss" provision of Section 724 to be found in Section 735(a).

If a corporate partner receives assets from the liquidation of a controlled corporation where the stock of the corporation was distributed to the corporate partner by the partnership, IRC Section 732(f) requires a special rule to be applied. The corporate partner's bases in the liquidated corporation's assets are reduced by the difference between the partnership's basis in the stock of the liquidated corporation and the partner's basis in the stock after receipt of the stock in the partnership distribution.

DISPROPORTIONATE DISTRIBUTIONS

The previous discussions have dealt with the general rules for proportionate distributions. In practice, few distributions, especially in liquidation of an interest, are proportional. If there were no special rules under Section 751(b), parties could use the general distribution rules to favorably characterize income for a recipient partner. Section 751(b) overrides the general distribution rules when a partner receives a disproportionate distribution of the partnership's hot assets.

Definition of a Hot Asset

Unrealized receivables and appreciated inventory are considered "hot" because their disposition produces ordinary income. IRC Section 751 applies to sales and exchanges as well.

Unrealized Receivables

An unrealized receivable is the right to be paid for goods delivered (or to be delivered) or services rendered (or to be rendered) to the extent such payment would constitute ordinary income when collected and the payment has not previously been included in income under the partnership's method of accounting (IRC Section 751(c)).

However, for hot asset purposes, the term expands beyond what accountants would generally consider to be receivables, picking up most ordinary income recapture items. That happens simply because the IRC at Section 751(c) includes such items in its definition of "hot assets," making this provision one of the best introductions for new tax researchers about the importance of checking provisions for any unique definitions that may go against common usage of a term.

The following are also included in the definition of "unrealized receivables" to the extent ordinary income would have resulted if the property had been sold at its FMV:

- Mining property (IRC Section 617(f)(2))
- DISC stock (IRC Section 992(a))
- Personal property (IRC Section 1245(a)(3)), including amortizable intangibles defined in IRC Section 197.
- Real property (IRC Section 1250(c)), including any basis reduction made under IRC Section 108(c)
- Stock in certain foreign corporations (IRC Section 1248)
- Farmland (IRC Section 1252(a))
- Franchises, trademarks, or trade names (IRC Section 1253(a)
- Oil, gas, or geothermal property (IRC Section 1254)
- Market discount bonds (IRC Section 1278)
- Short-term obligations (IRC Section 1283)

EXAMPLE

Depreciable Property as a Hot Asset

Bigger Partnership owns a piece of equipment with a current FMV of $20,000 and the following tax attributes:

Original Cost	$15,000
Accumulated Depreciation	$10,000
Net Book Value	$5,000

Appreciated Inventory

In addition to unrealized receivables, hot assets also include appreciated inventory items. Inventory items are:

- stock in trade or other property of a kind includable in inventory or property held primarily for sale to customers in the ordinary course of business;
- any other property that, on sale, would be classified as property other than a capital asset or IRC Section 1231 property (for an accrual basis taxpayer, this includes accounts receivable);
- any other property that, on sale, would result in gain taxable under IRC Section 1246(a) relating to gain on foreign investment company stock; and
- any other property that, if directly held by the partner selling his interest, would be property described in the three other categories listed (IRC Section 751(d)(2)).

Items that constitute unrealized receivables are automatically hot assets irrespective of their percentage of total assets.

For a sale of a partnership interest, inventory items don't have to be appreciated to be treated as hot assets. However, for property distributions, inventory is treated as substantially appreciated if its FMV exceeds 120% of the partnership's basis in the inventory (IRC Section 751(b) (3)(A)).

As expected, there is an anti-abuse rule: any property acquired with the principal purpose of reducing the inventory item's appreciation below 120% is disregarded when determining whether the 120% threshold is met.

Application of Hot Asset Rules to Distributions

The code presumes a hypothetical proportionate distribution with a transfer back to the partnership of the share of assets not actually received for those actually distributed. This can result in gain to both parties. At the partner level, it is a three-step process.

- The partner is deemed to receive a proportionate distribution of all assets.
- The partner takes a carryover basis in the assets and reduces the interest basis by that amount.
- The partner immediately exchanges his interest in the hypothetical assets received for what was actually received. This may result in a gain.
- The partnership has a two-step process.
- The partnership makes a proportional distribution of all its assets to the partner.
- The partnership immediately reacquires the hypothetically distributed assets in return for what it actually distributed. This may result in a gain and an increased basis in the retained assets.

It should be noted that this process is only necessary when there are hot assets and the partnership does not distribute a proportionate share of both hot and non-hot assets. For example, a distribution of cash alone while the partnership continues to hold hot assets is a disproportionate distribution.

EXAMPLE

Section 751

Profitable Partnership has the following simplified balance sheet:

	Tax Basis	Fair Market Value
Inventory	$320,000	$400,000
Capital $ Section 1231 Assets	$600,000	$800,000
Total Assets	$920,000	$1,200,000
Capital: Donna	$230,000	$300,000
Capital: Others	$690,000	$900,000
Total Liabilities and Capital	$920,000	$1,200,000

The inventory is appreciated. Donna has a 25% interest in the capital, profits, and losses. Thus, Donna has a 25% interest in the ordinary income that would be generated by the sale of the inventory. If Donna receives a proportional liquidating distribution of all assets of the partnership, then her share of the basis in the inventory is $80,000. The basis in the other assets is $150,000. The ordinary income potential is retained under the five-year rule.

Assume that instead of a proportionate distribution, Donna receives capital assets worth $300,000 (partnership basis of $250,000) in liquidation of her interest. Under the general rules, there would be no gain or loss and Donna takes a basis of $230,000 in assets. If Donna sells the assets for $300,000, there will be a recognized capital gain of $70,000. Art and Cal will recognize all of the ordinary income from the inventory. Section 751 was enacted to bar such recharacterization of income.

The distribution is considered disproportionate because Donna did not receive any inventory. Section 751 applies the following result.

- Donna is deemed to receive a proportionate share of all partnership assets. The inventory has an FMV of $100,000.
- Donna takes an $80,000 basis in the inventory and her remaining basis in her partnership interest is $150,000.
- Donna exchanges her inventory for capital assets of equal value: $100,000.

This triggers recognition of a $20,000 gain, which is ordinary income to her.

- Donna takes a basis of $100,000 in the acquired capital assets.
- The remaining $200,000 of capital assets represents her proportionate share and the general rules apply so she takes a basis of $150,000 in those. Her total basis is now $250,000.

The partnership is deemed to have distributed $100,000 of inventory and then exchanged it for capital assets worth $100,000. The capital assets have an inside basis of $75,000; thus, there is a recognized gain of $25,000. The partnership takes a cost basis of $100,000 in the acquired inventory.

Proposed Regulations on Hot Asset Treatments

Proposed regulations have been issued by the IRS (REG-151416-06) that would change the methods used to compute amounts included as income under the hot asset rules for partners in a partnership.

The proposed regulations follow generally the methods proposed by the IRS in Notice 2006-14 that initially proposed changing the regulations impacting this situation and asking for comments. The IRS indicated that the comments they received generally were favorable for replacing the "gross value" approach under current regulations with a "hypothetical sale" approach for determining if there has been a change in a partner's share of hot assets and how much income should be recognized.

The preamble to the proposed regulations describes the hypothetical sale approach as follows:

> As described in this preamble, the hypothetical sale approach requires a partnership to compare: (1) the amount of ordinary income (or ordinary loss) that each partner would recognize if the partnership sold its property for fair market value immediately before the distribution with (2) the amount of ordinary income (or ordinary loss) each partner would recognize if the partnership sold its property, and the distributee partner sold the distributed assets, for fair market value immediately after the distribution.

That allocation of income would include allocations required to be made pursuant to IRC Section 704(c) to the partner in making this determination, as well as taking into account any basis adjustment pursuant to Section 743, if applicable, to the partner.

The partnership, if it keeps capital accounts, will be required to revalue Section 704(b) book capital accounts pursuant to Reg. Section 1.704-1(b)(2)(iv)(f) if it distributes money or property (other than a de minimis amount) to a partner as consideration for his interest when the partnership owns Section 751 property. If the partnership does not maintain Section 704(b) capital accounts, the partnership must conform to this requirement by undertaking a deemed sale calculation.

If a partner receiving property triggers a Section 734(b) basis adjustment (i.e., a Section 754 election is in place), then the distributee partner will be required to recognize a capital gain equal to the amount necessary to remove that Section 734(b) basis adjustment. If there is no Section 734(b) issue but the partner faces a basis adjustment under Section 732(a)(2) or (b), the partner may elect to recognize a capital gain in the amount of the required basis reduction in lieu of reducing basis.

A partner making this election must notify the partnership of his intent to make this election and report the capital gain on his return. The regulations specifically provide that no late election relief will be available by asking for a letter ruling under Section 301.9100-3 even though the election date is set by regulation.

The regulations would also make changes to the regulations under Section 704(c). First, the preamble notes:

> [B]ecause the hypothetical sale approach relies on the principles of Section 704(c) to preserve a partner's share of the unrealized gain and loss in the partnership's Section 751 property, these proposed regulations make several changes to the regulations relating to Section 704(c). Specifically, the proposed regulations revise Section 1.704-1(b)(2)(iv)(f), regarding revaluations of partnership property, to make its provisions mandatory if a partnership distributes money or other property to a

> partner as consideration for an interest in the partnership, and the partnership owns Section 751 property immediately after the distribution. (A partnership that does not own Section 751 property immediately after the distribution may still revalue its property under the existing regulation, but is not required to do so under these proposed regulations.) If a partnership does not maintain capital accounts in accordance with Section 1.704- 1(b)(2)(iv), the partnership must comply with this requirement by computing each partner's share of gain or loss in each partnership asset prior to a distribution, and making future allocations of partnership items in a manner that takes these amounts into account (making subsequent adjustments for cost recovery and other events that affect the property basis of each such asset).

Tiered partnerships would be impacted by the following change to the revaluation rules:

> In addition, the proposed regulations contain a special revaluation rule for distributing partnerships that own an interest in a lower-tier partnership. Because a partnership's Section 751 property includes, under Section 751(f), the partnership's proportionate share of Section 751 property owned by any other partnership in which the distributing partnership is a partner, these proposed regulations also require a partnership in which the distributing partnership owns a controlling interest (which is defined as a greater than 50 percent interest) to revalue its property if the lower-tier partnership owns Section 751 property immediately after the distribution. If the distributing partnership owns a non-controlling (that is, less than or equal to 50 percent) interest in a lower-tier partnership, these proposed regulations require the distributing partnership to allocate its distributive share of the lower- tier partnership's items among its partners in a manner that reflects the allocations that would have been made had the lower-tier partnership revalued its partnership property.

The IRS and the Treasury Department are aware that in some instances a distributing partnership may be unable to obtain sufficient information to comply with this requirement from a lower-tier partnership in which the distributing partnership holds a noncontrolling interest. We request comments on reasonable approaches to address this issue.

The preamble also discusses the options for dealing with Section 704(c) issues in the case of revaluations in these cases. The preamble notes:

> [U]pon the revaluation of partnership property in connection with a partnership distribution, the regulations under Section 704(c) permit a partnership to choose any reasonable method to account for the built-in gain or built-in loss that is consistent with the purpose of Section 704(c). If property with built-in gain decreases in value (or property with built-in loss increases in value), then the partnership may be unable to allocate tax losses (or gains) to a non-contributing partner in an amount equal to the partner's economic loss (or gain). If the property with built-in gain (or loss) is Section 751 property, then the inability to allocate those tax losses (or gains) may cause ordinary income to shift among the partners. The regulations under Section 704(c) provide two reasonable methods for a partnership to allocate items to cure or remediate that shift. However, the regulations under Section 704(c) also provide a third reasonable method, the traditional method, under which the shift of ordinary income is not cured. The IRS and the Treasury Department are aware that distortions created under the Section 704(c) traditional method may cause ordinary income to shift among partners. However, the regulations under Section 704(c) contain an anti-abuse rule that provides that a method is not reasonable if, for example, the event that results in a reverse Section 704(c) allocation 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 built-in loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. The IRS and the Treasury Department believe that this anti-abuse provision under Section 704(c) properly addresses the possibility that taxpayers would use the traditional method to shift ordinary income.

The proposed regulations would also remove the "deemed asset exchange" that is used to swap hot asset and non-hot asset properties in such a situation, but they do not replace it with a mandatory method for computing the hot asset income inclusion. The IRS noted that both a deemed gain and a deemed asset exchange approach may, in certain circumstances, produce superior results.

Thus, the preamble notes:

> These proposed regulations withdraw the asset exchange approach of the current regulations, but do not require the use of a particular approach for determining the tax consequences of a Section 751(b) distribution. Instead, these proposed regulations provide that if, under the hypothetical sale approach, a distribution reduces a partner's interest in the partnership's Section 751 property, giving rise to a Section 751(b) amount, then the partnership must use a reasonable approach that is consistent with the purpose of Section 751(b) to determine the tax consequences of the reduction. Except in limited situations, a partnership must continue to use the same approach, once chosen, including after a termination of the partnership under Section 708(b)(1)(B). Note that a technical termination due to ownership change under Section 708(b)(1)(B) was repealed by the 2017 Tax Cuts and Jobs Act for taxable years beginning after 2017. These proposed regulations include examples in which the approach adopted is generally reasonable based on the facts of the examples, and one example in which it is determined that the adopted approach is not reasonable based on the facts of the example.

These excerpts are a rough summary of some of the provisions found in this proposed rewrite of the hot asset rules. As well, the IRS is asking for additional comments for other related areas that would

be impacted by any rewrite of these rules. The regulations provide a series of examples demonstrating how the rules would apply, which can be found on the IRS website in Reg. Section 1.751-1(g). The examples are reproduced as follows:

EXAMPLE 1

(i)(A) A and B are equal partners in personal service partnership PRS. A contributed nondepreciable capital assets (the "Capital Assets") to PRS with a basis and fair market value of $14,000. B contributed unrealized receivables described in paragraph (c) of this section (the "Unrealized Receivables") to PRS with a basis of zero and fair market value of $14,000. Later, when the fair market value of the Capital Assets had declined to $2,000, B transferred its interest in PRS to T for $9,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) was as follows:

Assets

	Adjusted Basis	Fair Market Value
Cash	$ 4,000	$ 4,000
Capital Assets	14,000	2,000
Unrealized Receivables	0	14,000
Total	18,000	20,000

Liabilities and Capital

	Adjusted Basis	Fair Market Value
Liabilities	$2,000	$2,000
Capital:		
A	15,000	9,000
B	1,000	9,000
Total	18,000	20,000

(B) The total amount realized by B is $10,000, consisting of the cash received, $9,000, plus $1,000, B's share of the partnership liabilities assumed by T. See Section 752. B's interest in the partnership property includes an interest in the partnership's Unrealized Receivables. B's basis in its partnership interest is $2,000 ($1,000, plus $1,000, B's share of partnership liabilities). If Section 751(a) did not apply to the sale, B would recognize $8,000 of capital gain from the sale of the interest in PRS. However, Section 751(a) does apply to the sale.

(ii) For purposes of Section 751(a), the amount of money or the fair market value of property received by the partner in exchange for all or part of his partnership interest must take into account the partner's share of income or gain from Section 751 property. If PRS sold all of its Section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $14,000 of ordinary income from the sale of PRS's Unrealized Receivables under Section 704(c). Therefore, B will recognize $14,000 of ordinary income with respect to the Unrealized Receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of Section 751 ($8,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($14,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $6,000 capital loss.

EXAMPLE 2

(i) A, B, and C each contribute $120 to partnership ABC in exchange for a 1/3 interest. A, B, and C each share in the profits and losses of ABC in accordance with their 1/3 interest. ABC purchases land for $100 in Year 1.

At the end of Year 3, when ABC holds $260 in cash and land with a value of $100 and has generated $90 in zero-basis unrealized receivables, ABC distributes $50 cash to C in a current distribution, reducing C's interest in ABC from 1/3 to 1/4. ABC has a Section 754 election in effect. To determine if the distribution is a distribution to which Section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under Section 1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	120	150
Totals	360	450		360	450

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $30 of net income from ABC's Section 751 property. Accordingly, A, B, and C's net Section 751 unrealized gain immediately before the distribution is $30 each under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Cash	$210	$210	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	70	100
Totals	310	400		310	400

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, A, B, and C would each still be allocated $30 of net income from ABC's Section 751 property pursuant to Section 1.704-3(a)(6). C did not receive any Section 751 property in the distribution. Accordingly, A, B, and C's net Section 751 unrealized gain immediately after the distribution is $30 each under paragraph (b)(2)(iii) of this section.

(iv) Because no partner's net Section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, and because no partner's net Section 751 unrealized loss is greater immediately after the distribution than immediately before the distribution, the distribution is not a Section 751(b) distribution under paragraph (b)(2)(i) of this section. Accordingly, Section 751(b) does not apply to the distribution.

EXAMPLE 3

(i) Assume the same facts as in Example 2 of this paragraph (g), but assume ABC distributes $150 cash to C in complete liquidation of C's interest. To determine if the distribution is a distribution to which Section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under Section 1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	100	100	C	120	150
Totals	360	450		360	450

If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of these assets immediately before the distribution, A, B, and C would each be allocated $30 of net income from ABC's Section 751 property. Accordingly, A, B, and C's net Section 751 unrealized gain immediately before the distribution is $30 each under paragraph (b)(2)(ii) of this section.

(iii)(A) Because ABC has elected under Section 754, and because A recognizes $30 gain on the distribution of cash, the basis of the real property is increased to $130 under Section 734(b).

After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized Receivable	0	90	B	120	150
Real Property	130	100	C	0	0
Totals	240	300		240	300

Because C is no longer a partner in ABC, C would not be allocated any net income from ABC's Section 751 property immediately after the distribution. Also, C did not receive any Section 751 property in the distribution. Accordingly, C's net Section 751 unrealized gain immediately after the distribution is $0 under paragraph (b)(2)(iii) of this section.

Because C's net Section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, Section 751(b) applies to the distribution. Under paragraph (b)(2)(i) of this section, C has a Section 751(b) amount equal to $30, the amount by which C's share of pre-distribution net Section 751 unrealized gain ($30) exceeds C's share of post- distribution net Section 751 unrealized gain ($0). Accordingly, paragraph (b)(3)(i) of this section requires C to recognize $30 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first

of which is described in paragraphs (v) and (vi) of this example, and the second of which is described in paragraphs (vii) and (viii) of this example.

Assume ABC adopts an approach under which, immediately before the Section 751(b) distribution, C is deemed to recognize $30 of ordinary income. To reflect C's recognition of $30 of ordinary income, C increases its basis in its ABC partnership interest by $30, and the partnership increases its basis in the unrealized receivable by the $30 of income recognized by C, immediately before the distribution. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the Section 751(b) distribution immediately prior to the cash distribution, ABC's modified balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$260	$260	A	$120	$150
Unrealized Receivable	30	90	B	120	150
Real Property	100	100	C	150	150
Totals	390	450		390	450

After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. Accordingly, C recognizes no gain or loss under Section 731(a) upon the distribution. Because C recognizes no gain on the distribution, the basis of the partnership real property is not adjusted. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Cash	$110	$110	A	$120	$150
Unrealized Receivable	30	90	B	120	150
Real Property Totals	100	100	C	0	0
	240	300		240	300

Assume alternatively that ABC adopts an approach under which, immediately before the Section 751(b) distribution, C is deemed to—

(A) Receive a distribution of ABC's unrealized receivables with a fair market value of $30 and a tax basis of $0;

(B) Sell the unrealized receivable to ABC in exchange for $30, recognizing $30 of ordinary income; and

(C) Contribute the $30 to ABC. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the Section 751(b) distribution immediately prior to the cash distribution, ABC's modified balance sheet is the same as the balance sheet shown in paragraph (v) of this example.

(viii) After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. The tax consequences under the rules of Sections 731 through 736 are the same tax consequences described in paragraph (vi) of this example.

EXAMPLE 4

(i) A and B are equal partners in a partnership, AB, that owns Unrealized Receivable with a fair market value of $50 and nondepreciable real property with a basis of $50 and a fair market value of $100. A has an

adjusted basis in its partnership interest of $25, and B has an adjusted basis in its partnership interest of $50. The partnership has a Section 754 election in effect, and B has a basis adjustment under Section 743(b) of $25 that is allocated to Unrealized Receivable. AB distributes Unrealized Receivable to A in a current distribution. To determine if the distributionis a distribution to which Section 751(b) applies, AB must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) AB makes a non-mandatory revaluation of its assets and its partners' capital accounts are increased under Section 1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, AB's balance sheet is as follows:

	Tax	Basis Adj.	Book	Capital	Tax	Special Basis	Book
Unrealized Receivable	0	25	50	A	25		75
Real Property	50		100	B	25	25	75
Totals	50	25	150		50	25	150

If AB disposed of all of its assets in exchange for cash in amounts equal to the fair market values of these assets immediately before the distribution, A and B would each be allocated $25 of net income from AB's Section 751 property. However, B's net income from Unrealized Receivable would be offset by its $25 Section 743 adjustment. Section 1.743-1(j)(3). Accordingly, A and B's net Section 751 unrealized gain immediately before the distribution are $25 and $0, respectively, under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), AB's balance sheet would be as follows:

	Tax	Basis Adj.	Book	Capital	Tax	Carryover Adjustment	Book
Carryover Adjustment		25	0	A	25		25
Real Property	50		100	B	25	25	75
Totals	50	25	100		50	25	100

If AB disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, no partner would be allocated net income or loss from Section 751 property. However, B has a carryover basis adjustment to ordinary income property of $25 under Sections 1.743-1(g) (2)(ii) and 1.755-1(c)(4), which B must treat as applied to Section 751 property with fair market value of $0 pursuant to paragraph (b)(2)(ii) of this section. Accordingly, B's net Section 751 unrealized loss immediately after the distribution is $25 under paragraph (b)(2)(iii)(A) of this section. If, immediately after the distribution, A disposed of Unrealized Receivable in exchange for $50 cash, A would recognize $50 of net income from Section 751 property. Accordingly, A's net Section 751 unrealized gain immediately after the distribution is $50 under paragraph (b)(2)(iii)(B) of this section.

Because B's net Section 751 unrealized loss immediately after the distribution ($25) exceeds B's net Section 751 unrealized loss immediately before the distribution ($0), the distribution is a Section 751(b) distribution. Under paragraph (b)(2)(i) of this section, B has a Section 751(b) amount equal to $25, the difference of B's share of pre-distribution net Section 751 unrealized gain ($0) and B's share of post distribution net Section 751 unrealized loss ($25). Accordingly, paragraph (b)(3)(i) of this section requires B

to account for $25 of ordinary income using a reasonable approach consistent with the purpose of this section.

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$0	$90	A	$0	$100
Unrealized Receivable 2	0	30	B	0	100
Real Property	0	180	C	0	100
Totals	0	300		0	300

(iv) Assume AB adopts an approach under which, immediately before the Section 751(b) distribution, B is deemed to—

(A) Receive a distribution of Unrealized Receivable with a fair market value of $25 and a tax basis of $25 (which consists of B's Section 743(b) basis adjustment and is determined solely for purposes of applying a reasonable method consistent with the purposes of Section 751(b));

(B) Sell Unrealized Receivable to AB in exchange for $25, so that B recognizes $0 of ordinary income, and AB receives Unrealized Receivable with a basis of $25; and

(C) Contribute the $25 to AB. Provided the partnership applies the approach consistently for all Section 751(b) distributions, AB's adopted approach is reasonable. After taking into account the tax consequences of the Section 751(b) distribution, AB's modified balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
			A	0	25
Real Property	50	100	B	50	75
Totals	50	100		50	100

(v) After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. Accordingly, A recognizes no gain on the distribution of Unrealized Receivable, which A takes with a basis of $25.

EXAMPLE 5

Capital Gain Recognition Required

(i) A, B, and C are each 1/3 partners in a partnership, ABC, that holds Unrealized Receivable 1 with a fair market value of $90, Unrealized Receivable 2 with a fair market value of $30, and nondepreciable real property with a fair market value of $180. The partnership has a Section 754 election in effect. Each of the partners has an adjusted basis in its partnership interest of $0 with a fair market value of $100. None of the partners has a capital loss carryforward. ABC distributes to A Unrealized Receivable 1 in a current distribution. To determine if the distribution is a distribution to which Section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets and its partners' capital accounts are increased under Section 1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	$0	$10
			B	0	100
Real Property	0	180	C	0	100
Totals	0	210		0	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $40 of net income from ABC's Section 751 property ($30 each from Unrealized Receivable 1 and $10 each from Unrealized Receivable 2). Accordingly, A, B, and C's net Section 751 unrealized gain immediately before the distribution is $40 each under paragraph (b)(2)(ii) of this section.

(iii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

(B) If ABC disposed of all of its assets in exchange for cash in amounts equal to the fair market values of those assets immediately after the distribution, A, B, and C would each be allocated $10 of net income from ABC's Section 751 property ($10 each from Unrealized Receivable 2). If immediately after the distribution, A disposed of Unrealized Receivable 1 in exchange for $90 cash, A would recognize $90 of net income from Section 751 property. Accordingly, B and C's net Section 751 unrealized gain immediately after the distribution is $10 each under paragraph (b)(2)(iii)(A) of this section, and A's is $100 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iv) Because B and C's net Section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a Section 751(b) distribution. Under paragraph (b)(2)(i) of this section, each of B and C has a Section 751(b) amount equal to $30, the amount by which each partner's share of pre-distribution net Section 751 unrealized gain ($40) exceeds its share of post distribution net Section 751 unrealized gain ($10). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $30 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers three approaches, the first of which is described in paragraphs (v) and (vi) of this example, the second of which is described in paragraphs (vii) and (viii) of this example, and the third of which is described in paragraph (ix) of this example.

(v) Assume ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to recognize $30 of ordinary income. To reflect B and C's recognition of $30 of ordinary income, B and C increase their bases in their ABC partnership interests by $30 each, and the partnership increases its basis in Unrealized Receivable 1 by $60 immediately before the distribution to A. Following the distribution to A, A's basis in Unrealized Receivable 1 is $0 under Section 732(a)(2). Because ABC has elected under Section 754, the distribution of Unrealized Receivable 1 to A would result in a $60 Section 734(b) adjustment to Unrealized Receivable 2. See Section 1.755-1(c)(1). Because that basis adjustment would have altered the amount of net Section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $60 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to paragraph (b)(3)(ii) (A) of this section. This gain recognition increases A's basis in its ABC partnership interest by $60 immediately before the distribution to A, eliminating the Section 734(b) adjustment. See Section 732(a)(2). In addition, the partnership increases its basis in Real Property by $60 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse Section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately prior to the distribution is as follows:

Unrealized Receivable 1	$60	$90	A	$60	$100
Unrealized Receivable 2	0	30	B	30	100
Real Property	60	180	C	30	100
Totals	120	300		120	300

(vi) After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. Thus, Unrealized Receivable 1 would take a $60 basis in A's hands under Section 732(a), and no Section 734(b) adjustment would be made to Unrealized Receivable 2. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	$0	$10
			B	30	100
Real Property	60	180	C	30	100
Totals	60	210		60	210

(vii) Assume alternatively that ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of Unrealized Receivable 1 with a fair market value of $30 and tax basis of $0;

(B) Sell the unrealized receivable to ABC for $30, recognizing $30 of ordinary income; and

(C) Contribute the $30 to ABC. For the same reasons stated in paragraph (v) of this example, A recognizes capital gain of $60. To accomplish this, A, immediately before the Section 751(b) distribution, is deemed to:

(1) Receive a distribution of Real Property with a fair market value of $60 and tax basis of $0;

(2) Sell the Real Property to ABC for $60, recognizing $60 of capital gain; and

(3) Contribute the $60 to ABC.

(viii) The partnership treats the $60 of gain recognized by A as reducing A's $60 reverse Section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. Before taking into account the tax consequences of the Section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (v) of this example. After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. The tax consequences under the rules of Sections 731 through 736 are the same tax consequences described in paragraph (vi) of this example.

(ix) Assume alternatively that A does not recognize capital gain of $60. As a result, upon the distribution of Unrealized Receivable 1 to A, ABC makes a $60 Section 734(b) adjustment to Unrealized Receivable 2. The adopted approach is not reasonable because it is contrary to paragraph (b)(3)(ii)(A) of this section.

EXAMPLE 6

Capital Gain Recognition Required. (i)(A) Assume the same facts as Example 5 of this paragraph (g), except that Unrealized Receivable 1 has a $9 tax basis, and each of the partners has an adjusted basis in its partnership interest of $3. Before the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 1	$9	$90	A	$3	$100
Unrealized Receivable 2	0	30	B	3	100
Real Property	0	180	C	3	100
Totals	9	300		9	300

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately before the distribution, A, B, and C would each be allocated $37 of net income from ABC's Section 751 property ($27 each from Unrealized Receivable 1 and $10 each from Unrealized Receivable 2). Accordingly, A, B, and C's net Section 751 unrealized gain immediately before the distribution is $37 each under paragraph (b)(2)(ii) of this section.

(ii)(A) After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$6	$30	A	$0	$10
			B	3	100
Real Property	0	180	C	3	100
Totals	6	210		6	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately after the distribution, taking into account the $6 Section 734(b) adjustment allocated to Unrealized Receivable 2, A, B, and C would each be allocated $8 of net income from ABC's Section 751 property ($8 each from Unrealized Receivable 2). If, immediately after the distribution, A disposed of Unrealized Receivable 1 for cash in an amount equal to its fair market value, A would recognize $87 of net income from Section 751 property. Accordingly, B and C's net Section 751 unrealized gain immediately after the distribution is $8 each under paragraph (b)(2)(iii)(A) of this section, and A's is $95 under paragraphs (b)(2) (iii)(A) and (B) of this section.

(iii) Because B and C's net Section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a Section 751(b) distribution. Under paragraph (b)(2)(i) of this section, each of B and C has a Section 751(b) amount equal to $29, the amount by which each partner's share of pre-distribution net Section 751 unrealized gain ($37) exceeds its share of post-distribution net Section 751 unrealized gain ($8). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C to recognize $29 of ordinary income using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (iv) and (v) of this example, and the second of which is described in paragraphs (vi) and (vii) of this example.

(iv) Assume ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to recognize $29 of ordinary income. To reflect B and C's recognition of $29 of

ordinary income, B and C increase their bases in their ABC partnership interests by $29 each, and the partnership increases its basis in Unrealized Receivable 1 by $58 to $67 immediately before the distribution to A. Following the distribution to A, A's basis in Unrealized Receivable 1 is $3 under Section 732(a)(2). Because ABC has elected under Section 754, the distribution of Unrealized Receivable 1 to A would result in a $64 Section 734(b) adjustment to Unrealized Receivable 2 (rather than the $6 Section 734(b) adjustment computed prior to the application of this section). See Section 1.755-1(c)(1). Because that additional basis adjustment would have altered the amount of net Section 751 unrealized gain or loss computed under paragraph (b) (2) of this section, A must recognize $58 of capital gain prior to the distribution of Unrealized Receivable 1 pursuant to paragraph (b)(3)(ii)(A) of this section.

This gain recognition increases A's basis in its ABC partnership interest by $58 to $61 immediately before the distribution to A. In addition, the partnership increases its basis in Real Property by $58 pursuant to paragraph (b)(3)(iii) of this section, and treats A's gain recognized as reducing A's $60 reverse Section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately prior to the distribution is as follows:

Unrealized Receivable 1	$67	$90	A	$61	$100
Unrealized Receivable 2	0	30	B	32	100
Real Property	58	180	C	32	100
Totals	125	300		125	300

(v) After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. Thus, A would take a $61 tax basis in Unrealized Receivable 1 under Section 732(a), and a $6 Section 734(b) adjustment would be made to Unrealized Receivable 2. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$6	$30	A	$0	$10
			B	32	100
Real Property	58	180	C	32	100
Totals	64	210		64	210

(vi) Assume alternatively that ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of Unrealized Receivable 1 with a fair market value of $29 and tax basis of $0;

(B) Sell the unrealized receivable to ABC for $29, recognizing $29 of ordinary income; and

(C) Contribute the $29 to ABC. For the same reasons stated in paragraph (iv) of this example, A recognizes capital gain of $58. To accomplish this, A, immediately before the Section 751(b) distribution, is deemed to:

(1) Receive a distribution of Real Property with a fair market value of $58 and tax basis of $0;

(2) Sell the Real Property to ABC for $58, recognizing $58 of capital gain; and

(3) Contribute the $58 to ABC.

(vii) The partnership treats the $58 of gain recognized by A as reducing A's $60 reverse Section 704(c) amount in the Real Property. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the Section 751(b) distribution, ABC's balance sheet is thesame as the balance sheet shown in paragraph (iv) of this example. After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. The tax consequences under the rules of Sections 731 through 736 are the same tax consequences described in paragraph (v) of this example.

EXAMPLE 7

Capital Gain Recognition Elective

(i)(A) Assume the same facts as described in Example 6 of this paragraph (g), including that ABC adopts the deemed gain approach described in paragraph (iv), except that ABC does not have a Section 754 election in effect. As in Example 6, each of A, B, and C has net Section 751 unrealized gain of $37 immediately before the distribution. After the distribution (but before taking into account any consequences under this section), ABC's balance sheet would be as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	0	10
			B	3	100
Real Property	0	180	C	3	100
Totals	0	210		6	210

(B) If ABC disposed of all of its assets for cash in an amount equal to the fair market value of such property immediately after the distribution, because there is no Section 734(b) adjustment allocated to Unrealized Receivable 2, A, B, and C would each be allocated $10 of net income from ABC's Section 751 property ($10 each from Unrealized Receivable 2). If, immediately after the distribution, A disposed of Unrealized Receivable 1 for cash in an amount equal to its fair market value, A would recognize $87 of net income from Section 751 property. Accordingly, B and C's net Section 751 unrealized gain immediately after the distribution is $10 each under paragraph (b)(2)(iii)(A) of this section, and A's is $97 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(ii) Because B and C's net Section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a Section 751(b) distribution. Under paragraph (b)(2)(i) of this Section B and C each have a Section 751(b) amount equal to $27, the amount by which those partners' shares of pre-distribution net Section 751 unrealized gain ($37), exceeds their shares of post-distribution net Section 751 unrealized gain ($10). Accordingly, paragraph (b)(3)(i) of this section requires each of B and C torecognize $27 of ordinary income using a reasonable approach consistent with the purpose of this section.

(iii) Assume ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to recognize $27 of ordinary income. To reflect B and C's recognition of $27 of ordinary income, B and C increase their bases in their ABC partnership interests by $27, and the partnership increases its basis in Unrealized Receivable 1 by $54 to$63 immediately before the distribution to A. The distribution to A results in an adjustment to the basis of the distributed Unrealized Receivable 1 under Section 732(a)(2), reducing the basis of Unrealized Receivable 1 in the hands of A to $3. Because ABC has not elected under Section 754 and does not have a substantial basis reduction under Section 734(d), this $60 decrease to the basis of Unrealized Receivable 1 will not affect the basis of other assets held by ABC. Thus,the distribution does not alter the amount of net Section 751 unrealized gain or loss computed under

paragraph (b)(2) of this section. Accordingly, A is not obligated under paragraph (b)(3)(ii)(A) of this section to recognize gain or income upon the distribution of Unrealized Receivable 1. However, A may elect to recognize $60 of capital gain under paragraph (b)(3)(ii)(B) of this section to eliminate the Section 732 basis adjustment to the distributed Unrealized Receivable 1 which would otherwise cause A's net Section 751 unrealized gain to be greater immediately after the distribution than it was immediately before the distribution. This gain recognition increases A's basis in its ABC partnership interest by $60 immediately before the distribution to A.

In addition, the partnership increases its basis in Real Property by $60 pursuant to paragraph (b)(3) (iii) of this section, and treats A's gain recognized as reducing A's $60 reverse Section 704(c) amount in the Real Property. A receives the distributed Unrealized Receivable 1 with a basis of $63, so that the distribution does not increase A's net Section 751 unrealized gain. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
Unrealized Receivable 2	$0	$30	A	0	10
			B	30	100
Real Property	60	180	C	30	100
Totals	60	210		60	210

EXAMPLE 8

(i) A, B, and C, each domestic corporations, are 1/3 partners in a domestic partnership ABC. ABC purchased 100% of the stock in two foreign corporations, X and Y. X and Y each has one share of stock outstanding. ABC has a basis of $15 in its X share with a fair market value of $150, and a basis of $3 in its Y share with a fair market value of $30. The earnings and profits of X that are attributable to ABC's X stock under Section 1248 are $135; the earnings and profits of Y that are attributable to ABC's Y stock are $27. ABC has a Section 754 election in effect. Each of A, B, and C has a partnership interest with an adjusted basis of $6 and a fair market value of $60. On January 1, 2013, ABC distributes the Y share to A in a current distribution. To determine if the distribution is a distribution to which Section 751(b) applies, ABC must apply the test set forth in paragraph (b)(2) of this section.

(ii)(A) Pursuant to paragraph (b)(2)(iv) of this section, ABC revalues its assets. Its partners' capital accounts are increased under Section 1.704-1(b)(2)(iv)(f) to reflect each partner's share of the unrealized gain in the partnership's assets. Before the distribution, ABC's balance sheet is as follows (with the shares of X and Y each reflected as having both an unrealized receivable component and a capital gain component):

	Tax	Book	Capital	Tax	Book
X stock (total)	$15	$150	A	$6	$60
Unrealized receivable	0	135	B	6	60
Capital gain asset	15	15	C	6	60
Y stock (total)	3	30			
Unrealized receivable	0	27			
Capital gain asset	3	3			
Totals	18	180		18	180

(B) If ABC disposed of all of its assets for cash in an amount equal to the assets' fair market value immediately before the distribution, A, B, and C would each be allocated $54 of net income from ABC's Section 751 property ($45 each from X stock and $9 each from Y stock). Accordingly, A, B, and C's net Section 751 unrealized gain immediately before the distribution is $54 each under paragraph (b) (2)(ii) of this section.

(A) After the distribution (but before taking into account any consequences underthis section), ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock (total)	$15	$150	A	$3	$30
Unrealized receivable	0	135	B	6	60
Capital gain asset	15	15	C	6	60
Totals	15	150		15	150

(B) If ABC disposed of its asset for cash in an amount equal to the fair market value of that asset immediately after the distribution, A, B, and C would each be allocated $45 of net income from ABC's Section 751 property pursuant to Section 1.704-3(a)(6). A, however, received Y stock, which continues to be Section 751 property in A's hands under Section 735(a), with a holding period that includes the partnership's holding period under Section 735(b). If A disposed of its Y stock for cash in an amount equal to its fair market value, A would recognize $27 of gain under Section 751(b) on the Y stock (a foreign corporation described in Section 1248) that is included in A's income under Section 1248 as a dividend to the extent of the attributable earnings. Accordingly,B and C's net Section 751 unrealized gain immediately after the distribution is $45 each under paragraph (b)(2)(iii)(A) of this section, and A's is $72 under paragraphs (b)(2)(iii)(A) and (B) of this section.

(iii) Because B and C's net Section 751 unrealized gain is greater immediately before the distribution than immediately after the distribution, the distribution is a Section 751(b) distribution. Under paragraph (b)(2)(i) of this section, B and C each have a Section 751(b) amount equal to $9, the amount by which those partners' shares of pre-distribution net Section 751 unrealized gain ($54) exceeds their shares of post-distribution net Section 751 unrealized gain ($45). Accordingly, paragraph (b) (3)(i) of this section requires each of B and C to recognize $9 as a dividend under Section 1248 using a reasonable approach consistent with the purpose of this section. ABC considers two approaches, the first of which is described in paragraphs (v) and (vi) of this example, and the second of which is described in paragraph (vii) of this example.

(iv) Assume ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to recognize $9 of gain includible as a dividend with respect to the distribution of the Y stock, which is treated as a sale or exchange for purposes of Section 1248. To reflect B and C's recognition of $9 of dividend income, B and C increase the bases in their ABC partnership interests by $9 each, and the partnership increases its basis in the Y share unrealized receivable component by $18 immediately before the distribution. The portion of the unrealized receivable component of the Y share that is deemed to be sold or exchanged under Section 1248 has a new holding period beginning on the day after the Section 751(b) distribution ("the new holding period portion"). The earnings and profits of $18 attributable to the new holding period portion of the Y share are 2/3 of the total earnings and profits attributable to the Y share immediately before the distribution (B and C's $18 aggregate gain recognized under Section 751(b) divided by $27, the aggregate of all the partners' net Section 751 unrealized gain immediately before the distribution).

The remaining earnings and profits are allocated tothe remainder of the Y share. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is

reasonable. After taking into account the tax consequences of the deemed gain approach described in this example, ABC's modified balance sheet immediately before the distribution is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$15	$150	A	$6	$60
Unrealized receivable	0	135	B	15	60
Capital gain asset	15	15	C	15	60
Y stock	21	30			
New holding period portion	18	18			
Unrealized receivable	0	9			

(v) After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. Accordingly, the basis of the distributed Y stock in A's hands is limited under Section 732(a)(2) to A's $6 basis in its partnership interest. Pursuant to Section 732(c)(3)(B), the $15 decrease in basis from $21 to $6 must be allocated to the distributed components of the Y stock in proportion to their respective adjusted bases. A must allocate the $15 decrease in basis in the Y stock between the new holding period portion (which has a basis of $18) and the remainder of the Y share (which has a basis of $3). Accordingly, A receives the new holding period portion of the Y share with an adjusted basis of $5.14 ($6 multiplied by ($18 divided by $21)), and the remainder of the Y share with an adjusted basis of $0.86 ($6 multiplied by ($3 divided by $21)). Because the basis of the distributed Y stock in A's hands was reduced from $21 (the basis of the Y stock in the hands of ABC) to $6 (the basis in A's hands), ABC must increase the basis of its remaining asset under Section 734(b)(1)(B) by $15. ABC must allocate the $15 under Section 1.7551(c)(1)(i) to the capital gain portion of the X stock. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$0	$30
Unrealized receivable	0	135	B	15	60
Capital gain asset	30	15	C	15	60
Totals	30	150		30	150

(vi) Assume alternatively that ABC adopts an approach under which, immediately before the Section 751(b) distribution, B and C are each deemed to:

(A) Receive a distribution of the portion of the partnership's Y stock with a fair market value of $9 and a tax basis of $0;

(B) Sell the Y stock back to ABC for $9, recognizing $9 of gain includible as a dividend; and

(C) Contribute the $9 to ABC. ABC will be deemed to have purchased for $18 a portion of the Y stock unrealized receivable component, which will have a new holding period. The deemed sale of Y stock by B and C to ABC will be treated as a sale or exchange for purposes of Section 1248. Provided that the partnership applies the approach consistently for all Section 751(b) distributions, Partnership ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed transaction, ABC's balance sheet is the same as the balance sheet shown in paragraph (v) of this example.

After taking into account the tax consequences of the Section 751(b) distribution, ABC's balance sheet is the same as the balance sheet shown in paragraph (vi) of this example.

(vii) Assume that in a later unrelated transaction, A sells its Y stock at a time when its fair market value, earnings and profits, and adjusted basis have not changed. The sale of Y stock by A is a sale or exchange subject to Section 1248. Pursuant to Section 1.732-1(c)(2)(v), in determining the dividend portion of its gain on the Y stock under Section 1248, A does not take into account the $15 decrease in basis under Section 732. Accordingly, upon the sale of the Y stock, A recognizes $9 of gain, the lesser of $9 ($0 gain on the new holding period portion ($18 fair market value minus $18 basis) plus $9 gain on the remainder ($12 fair market value minus $3 basis)) or $9 (earnings and profits attributable to the remainder of the Y share) as dividend income under Section 1248. A recognizes $15 of capital gain in addition to the $9 of dividend income ($30 amount realized minus $15 ($6 aggregate basis in Y share plus $9 Section 1248 dividend income)).

(viii) Assume that ABC also sells its X stock in a later unrelated transaction at a time when its fair market value has declined to $120 but earnings and profits have remained the same. ABC has not made an election under Section 1.755-1(c)(2)(vi). In determining the dividend portion of its gain on the X stock under Section 1248, ABC does not take into account the $15 increase in basis under Section 734(b). Upon the sale of the stock, ABC recognizes $105, the lesser of $105 ($120-$15) or $135 (earnings and profits attributable to the X stock for the partnership's holding period) as dividend income. In addition to the $105 of gain includible as a dividend, ABC recognizes $15 of capital loss ($120 amount realized minus $135 ($30 aggregate basis in X stock plus $105 Section 1248 dividend income)).

EXAMPLE 9

(i) Assume the same facts as in Example 8 of this paragraph (g), except assume that Partnership ABC makes an election under Section 1.755-1(c)(2)(vi). As in Example 8, paragraph (b)(3)(i) of this section requires each of B and C to recognize $9 as a dividend under Section 1248 using a reasonable approach consistent with the purpose of this section for the reasons described in paragraphs (ii) through (iv) of Example 8. Further assume that ABC adopts the deemed gain approach described in paragraph (v) of Example 8. As in Example 8, B and C are each deemed to recognize $9 of dividend income with respect to the distribution of the Y stock, which is treated as a sale or exchange for purposes of Section 1248. To reflect B and C's recognition of $9 of dividend income, B and C increase the bases in their ABC partnership interests by $9 each. The partnership increases its basis in the Y share unrealized receivable component by $18 immediately before the distribution. The portion of the unrealized receivable component of the Y share that is deemed to be sold or exchanged under Section 1248 has a new holding period beginning on the day after the Section 751(b) distribution ("the new holding period portion").

(ii) Because ABC makes an election under Section 1.755-1(c)(2)(vi), the distribution of the Y share to A results in a $15 Section 734(b) adjustment to the unrealized receivable component of the X share. Because that basis adjustment would have altered the amount of net Section 751 unrealized gain or loss computed under paragraph (b)(2) of this section, A must recognize $15 of gain with respect to the X share pursuant to paragraph (b)(3)(ii)(A) of this section. Also pursuant to paragraph (b)(3)(ii)(A) of this section, A's recognition of income with respect to the X stock is a sale or exchange for purposes of Section 1248 and begins a new holding period for this portion of ABC's X stock, including for purposes of attributing earnings and profits. This income recognition increases A's basis in its ABC partnership interest by $15 immediately before the distribution to A. In addition, the partnership increases its basis in the X share by $15, immediately before the distribution to A. The partnership treats the $15 of dividend income recognized by A as reducing A's $15 reverse Section 704(c) amount in the X stock. Provided the partnership applies the approach consistently for all Section 751(b) distributions, ABC's adopted approach is reasonable. After taking into account the tax consequences of the deemed gain approach described previously, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	$30	$150	A	$21	$60
Unrealized receivable	0	120	B	15	60
Capital gain asset	30	30	C	15	60
Y stock	21	30			
Unrealized receivable	0	9			
Capital gain asset	21	21			
Totals	51	180		51	180

(iii)(A) After determining the tax consequences of the Section 751(b) distribution, the rules of Sections 731 through 736 apply. Accordingly, the Y stock would take a $21 basis in A's hands under Section 732(a), and no Section 734(b) adjustment would be made to the X stock. After the distribution, ABC's balance sheet is as follows:

	Tax	Book	Capital	Tax	Book
X stock	**$30**	**$150**	**A**	**$21**	**$60**
Unrealized receivable	**0**	**120**	**B**	**15**	**60**
Capital gain asset	**30**	**30**	**C**	**15**	**60**
Totals	**30**	**150**		**30**	**150**

(B) If the partnership sells the X stock, the gain recognized is $120 ($150 – $30), all of which is recharacterized as a dividend under Section 1248. Because A's recognition of $15 of dividend income reduced A's reverse Section 704(c) amount in the X stock, this gain is allocated $45 to B, $45 to C, and $30 to A.

Hot Assets & Section 199A Qualified Business Income (QBI)

Any "hot asset" gain or loss recognized by a partner or partnership due to a sale or exchange of a partnership interest or a partnership distribution is considered an item of qualified business income by the partner or partnership.[57]

In explaining the need for this clarification in the regulations, the preamble notes that provisions in Section 199A related to publicly traded partnerships caused some to wonder if Section 751 gains were not QBI under Section 199A.

[57] Proposed Reg. Section 1.199A-2(b)(i)

The IRS discusses the concern and the agency's reasoning on why Section 751 gains and losses are properly part of QBI in the preamble to the proposed regulations:

> The Treasury Department and the IRS have received comments stating that it is unclear whether gain or loss that is treated as ordinary income under Section 751 should be QBI if the Section 751 income meets all of the other requirements to be QBI. This uncertainty is caused because Section 199A(e)(5) lists: (i) the taxpayer's allocable share of the QBI from a publicly traded partnership and (ii) income described in Section 751(a) as separate categories of qualified publicly traded partnership income, which could be read to imply that income described in Section 751 is not QBI. Section 1.199-5(f), issued under former Section 199, specifically included Section 751(a) or (b) gains as domestic production gross receipts.
>
> The Treasury Department and the IRS do not view the statutory reference to Section 751(a) gain as qualified PTP income to exclude Section 751 gain from being QBI, but rather view such reference as clarifying the rules for PTPs. Accordingly, proposed Section 1.199A-3(b)(1)(i) clarifies that any gain attributable to assets of a partnership giving rise to ordinary income under Section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and therefore, may constitute QBI if the other requirements of Section 199A and proposed Section 1.199A-3 are satisfied.
>
> The final regulations continue this position that ordinary income under Section 751(a) or (b) is qualified business income. (Regs. Section 1.199A-3(b)(1)(i))

SECTION 736 DISTRIBUTIONS

When partners leave a partnership, their interests can be acquired by one of two methods: either the other partners purchase the interest directly from the partner or the partnership liquidates the interest by one or more payments. If the second option is chosen, the amount of a liquidating distribution paid to a partner who is retiring from an ongoing partnership should theoretically equal the partner's proportionate interest in the value of the partnership assets.

While many think Section 736 involves only payments to retiring partners, it's actually much broader. Reg. Section 1.736-1(a)(1)(ii) defines *retirement* as any point at which the partner isn't a partner under local law. Thus, Section 736 can apply to any termination, including involuntary terminations.

Section 736 also applies to the liquidation of one partner in a two-partner partnership (Reg. Section 1.736- 1(a)(6)). A distribution under IRC Section 736 can be for the partnership interest (IRC Section 736(b)), a distribution of partnership income or a guaranteed payment (IRC Section 736(a)), or a combination of the two.

While both the purchase of a partnership interest and the liquidation of a partnership interest produce the same cash results, the tax treatment can be very different. A comparison of the two options demonstrates the differences.

Purchase of a Partnership Interest

- One or more of the other partners purchase the interest directly from the retiring partner.
- Taxable gain is the difference between the amount received and the basis of the partnership interest.
- Gain will usually be capital gain, subject to the application of Section 751.
- Basis is applied pro rata to payments so that income recognition occurs from the first payment.
- Any extended payments must include an interest provision, or interest will be imputed. Partnerships can make a Section 754 election to permit the acquiring partners to step up their share of the partnership's assets.
- If 50% or more of the partnership interests are transferred within a 12-month period the partnership terminated for tax purposes under prior law. The 2017 Tax Cuts and Jobs Act repealed this provision for partnership taxable years beginning after December 31, 2017.

Liquidation of a Partnership Interest

- The partnership makes the payments to the retiring partner.
- Any property distributed isn't taxed until sold by the partner.
- Gain will usually be capital gain, subject to the application of Section 751.
- Where the partner receives payments over time, no gain is recognized until all basis in the partnership interest has been recovered (an option to prorate basis is available). No loss is generally recognized until the last payment is made.
- A partnership can make a Section 754 election to permit the other partners to step up their share of the partnership's assets.
- It can be structured so that some of the payments are deductible by the partnership.
- No interest needs to be paid or imputed.
- It's not deemed to be a sale or exchange, so there is no partnership termination under the 50%-in-12-months rule under prior law. As indicated, the 2017 Tax Cuts and Jobs Act repealed this rule for partnership taxable years beginning after December 31, 2017.

In reality, partners may negotiate for—and partnerships may agree to pay—liquidating distributions in excess of the FMV of a partner's interest in the partnership. Section 736(b) provides that only the portion of the total distribution attributable to the partner's interest in the partnership assets is subject to the statutory rules dealing with partnership distributions.

Generally, where the partners and the partnership agree on a value to be placed on a partner's interest, the IRS will respect that valuation, so long as it is at arm's length (Reg. Section 1.736-1(b)(1)). That's because the interests of the parties are normally "adverse"—what's good for one from a tax perspective isn't good for the others. However, where the valuation isn't at arm's length,

the IRS will attempt to disregard it. In computing the gain or loss on an IRC Section 736(b) transaction, the general rules governing sales or exchanges of partnership interests will apply.

The remainder of the distribution, called a Section 736(a) payment, is not subject to the general rules for partnership distributions just discussed. These payments may be determined without regard to the income of the partnership and are generally classified as guaranteed payments. Accordingly, these are ordinary income to the partner and are deductible by the partnership.

EXAMPLE

Section 736

Joe is a 20% general partner in the Growfast Partnership. Joe retired from the business during the current year.

As of the date of his retirement, the partnership had the following balance sheet:

	Inside Basis	Fair Market Value
Cash	$50,000	$50,000
Business Assets	65,000	90,000
Total Assets	$115,000	$140,000
Debt	$5,000	$5,000
Capital:		
Joe	22,000	27,000
Others	88,000	108,000
Total Liabilities and Capital	$115,000	$140,000

Even though Joe's capital account balance was $22,000, the other partners agreed to pay Joe $40,000 cash in complete liquidation of his equity interest. The additional $13,000 was in grateful recognition of Joe's long years of faithful service.

The total liquidating payments consists of:

Actual Cash	$40,000
Relief of 20% of Debt	1,000
Total Cash Distribution	$41,000

Joe's 20% interest in the value of the partnership assets was $28,000, the value of his capital account and his 20% share of the partnership debt, or 20% of the FMV of the assets. As a result, only $28,000 of the liquidating payment is treated as a distribution. Assuming Joe's outside basis in his partnership interest is $23,000, Joe recognizes a $5,000 capital gain, which is equal to the excess of the cash distributed over his basis.

The $13,000 Section 736(a) payment was determined without regard to partnership income. Consequently, it is classified as a guaranteed payment, which Joe will recognize as ordinary income and the partnership will deduct.

Election to Ratably Include Gain

As noted earlier, payments for a partner's interest in partnership property is an IRC Section 736(b) payment and is treated as a sale or exchange for purposes of IRC Section 754. Thus, if a Section 754

election is in place, the remaining partners get a step up in basis for the payments. If no Section 754 election is in place, the payments have no tax impact on the partnership.

One significant difference, however, between a sale and exchange of a partnership interest and a payment under IRC Section 736(b) is that a withdrawing partner receiving a Section 736(b) payment recognizes no income until his entire basis in the partnership is recovered. However, the partner can elect to ratably include the gain in income over the series of payments, provided the number of payments is fixed (Reg. Section 1.736-1(b)(6)). This election is also available if there is an overall loss on the transaction.

EXAMPLE

Sale vs. IRC Section 736(B) Payment

Dick has a basis of $100,000 in his 25% partnership interest. The partnership holds only capital assets with a total value of $1,000,000. Dick is getting out of the partnership, and the other partners are considering whether to buy his interests themselves or pay him out by a series of Section 736(b) payments. In either case, the payments will be made over five years (disregard any interest issues).

If the partners buy Dick's interest, Dick will recognize $30,000 per year as a capital gain, computed as follows:

Total Sales Price	$250,000	(1,000,000 x 25%)
Basis	–100,000	
Gain	$150,000	(60% of sales price)

Annual payments will be $50,000, of which $30,000 will be taxable as capital gain. If, on the other hand, the payments are structured as Section 736(b) payments, then Dick will have no income in the first two years, since the payments of $50,000 represent a recovery of basis.

However, in years three to five, Dick will report the full amount of each payment as a capital gain.

A summary of the different tax consequences of the two methods is as follows:

Taxable Gain

Year	Sale	Section 736(b)
1	$30,000	$0
2	30,000	0
3	30,000	50,000
4	30,000	50,000
5	30,000	50,000

Since the payments are fixed, the IRS permits a partner to elect to report the gain ratably over the payments, just as if the transaction were a sale (Reg. Section 1.736-1(b) (6)). If the partnership has a Section 754 election in place, the partnership receives a step up in basis.

To the extent that the assets are depreciable (which they are not in this example), the partnership will increase its depreciation. To the extent that the increase is attributable to a Section 197 intangible, Reg. Section 1.197-2 provides that the basis adjustment created by a payment is amortized over the remainder of the 15-year amortization period.

Local Law Issues & Section 736

IRC Section 736 applies whenever a partner ceases to be a partner under local law and receives payments from the partnership in liquidation of his interest, regardless of the reason for his termination (Reg. Section 1.736-1(a)(1)(ii)). Thus, even an arguably illegal expulsion, where retirement payments are made to the expelled partner, can constitute a transaction to which IRC Section 736 applies (*Milliken v. Commissioner*, 72 T.C. 256 (1979)).

Automatic Section 736(a) Payments

Payments made with respect to unrealized receivables must always be considered Section 736(a) payments rather than distributions. Payments with respect to goodwill are similarly classified unless the partnership agreement specifies that a withdrawing partner will be paid for her share of goodwill.

The rule concerning goodwill applies to payments made to general partners by partnerships in which capital is not a material income-producing factor (a service partnership). Section 736(b) (3) provides that the capital is not a material income-producing factor if substantially all of the partnership's income consists of fees, commissions, or other compensation for personal or professional services performed by individuals.

Thus, a professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor, even though the practitioner has a substantial investment in professional equipment or in a physical plant, so long as the capital investment is only incidental to the professional practice.

Apparently, Congress did not change the rule for professional partnerships since such partnerships generally do not value goodwill in liquidating partnership interests.

The deductibility of Section 736(a) payments for other partnerships was changed in 1993, subject to a binding contract exception. The old rules, permitting deductions for other partnerships, can still be used if there was a binding contract to acquire a partner's interest in existence on January 4, 1993, and at all times thereafter.

Whether an LLC member can be treated as a general partner for purposes of IRC Section 736 is uncertain. An LLC member actively participating in the affairs of a professional LLC (i.e., a law firm) is arguably the practical equivalent of a general partner. There is virtually nothing directly on the issue, although in other areas, the IRS did conclude in PLR 9452024 that LLC members, although not limited partners, could be treated as limited partners for some provisions. Conversely, the ruling seems to indicate that a member can be a general partner for some tax code provisions. The case of *Renkemeyer, Campbell, & Weaver v. Commissioner*, LLP, 136 T.C. No. 7, suggests that a level of participation rule is the proper test.

Payments for unrealized receivables are treated as guaranteed payments, as are fixed payments for goodwill, unless the partnership agreement specifies that a withdrawing partner will be paid for her share of goodwill. Payments for goodwill, not provided for in the partnership agreement, that are not fixed are treated as a distributive share of income.

Tax Treatment of Section 736(a) Payments

If the payment to a service partner is a guaranteed payment, it is deductible by the partnership. The partner reports the guaranteed payment in the year with or within which ends the partnership year in

which the partnership is entitled to deduct the payment. If it is considered a distributive share, the other partner's stream of income will be reduced. However, to be a guaranteed payment, the payment must be made without regard to the income of the partnership (IRC Section 707(c)).

If the payment is not a guaranteed payment, then it is a distributive share of income. The partner reports the distributive share for the year with or within which the partnership year ends for which the payment is a distributive share.

Private Letter Ruling 200403056 holds that a law firm's payments to its retired partners under a bona fide retirement program will not be subject to self-employment tax as long as the requirements of IRC Section 1402(a)(10) and Reg. Section 1.1402(a)-17 are met. Those requirements are that the partner's capital is paid to him, his former partners have no personal obligations to him other than to pay his retirement benefits, and the partner renders no services to the partnership in any year in which retirement benefits are received.

Further, if payments are made on a periodic basis, pursuant to a written plan that provides for payments to continue until the partner's death, they are not subject to self-employment tax.

This ruling clarifies exactly how IRC Section 1402(a)(10) will apply and parts of the IRS explanation are surprising. First, the bulk of pension payments due under the law firm's plan was paid within five years of retirement; then payments of $100 per month were made for the partner's lifetime. Second, a partner could provide limited services "of counsel," be separately compensated for those services, and be subject to self-employment tax for that year without tainting payments received in other years.

Combination Sections 736(a) & 736(b) Payments

Where a combination of Section 736(a) and Section 736(b) payments are made, the income reported depends on the nature of the payment. If a partnership makes fixed payments for a fixed number of years, each annual payment must be prorated between the Section 736(b) and Section 736(a) amounts. The proration is based on the total amount of Section 736(b) payments compared to the total payments. Thus, for example, if the total payments are $500,000 and the Section 736(b) payments, part of that amount, total $200,000, 40% of each payment will be deemed to be a Section 736(b) payment.

This rule will apply even if the annual amounts paid vary, so long as the total is fixed. This can occur where the partnership limits its payout in any year, but then it must increase the payment to make up the shortfall in a future year.

When the payments are variable but the total amount is fixed, the pro rata amount is treated as a Section 736(b) payment, with the excess treated as a Section 736(a) payment. If the payment is not enough to cover the pro rata Section 736(b) amount, the excess Section 736(b) amount is carried forward to the succeeding year.

EXAMPLE

Variable Payments: Fixed Total Amount

Harry is retiring from the Vestige Partnership. Harry is to be paid out $200,000. Of this amount, $120,000 is a Section 736(b) payment and $80,000 is a Section 736(a) payment. The payment schedule is as follows:

Year	Total	§ 736(b)	§ 736(a)
2016	$20,000	$12,000	$8,000

2017	$40,000	$24,000	$16,000
2018	$40,000	$24,000	$16,000
2019	$40,000	$24,000	$16,000
2020	$60,000	$36,000	$24,000
Total	$200,000	$120,000	$80,000

The agreement also provides that the partnership can reduce a payment if there is insufficient cash flow. In fact, the following reflects the actual payments made:

Year	Total	§ 736(b)	§ 736(a)
2016	$20,000	$12,000	$8,000
2017	$40,000	$24,000	$16,000
2018	$20,000	$20,000	$0
2019	$60,000	$28,000	$32,000
2020	$60,000	$36,000	$24,000
Total	$200,000	$120,000	$80,000

If the payments are variable, with no fixed amount, the partner is deemed to have received Section 736(b) payments until his partnership basis is recovered. Thereafter, all payments become Section 736(a) payments.

Partnership Planning for Withdrawal

The complexities of IRC Section 736 and the consequences of various options make it clear that the best solution is to have the partners agree in a written document how the withdrawal payments are to be made. For example, the agreement could provide for the payment of goodwill as a Section 736(b) item. Other areas of potential controversy can also be addressed to prevent a bad tax result and, more importantly, a misunderstanding among the partners.

This illustrates one of the key areas that advisers need to be aware of in advising partnerships. The flexibility that partnerships provide in this and other areas is a key reason why significant time should be invested in discussing these very sorts of details and providing for them in the partnership agreement at a time when the parties aren't facing an imminent need to make a tax decision. In many cases, the interests of the parties will be dramatically different when the time comes to decide the tax treatment of items.

DISTRIBUTIONS & PRE-CONTRIBUTION GAIN OR LOSS

When a partner contributes property with pre-contribution gain or loss, such gain or loss is allocated to the contributing partner under Section 704(c). Under Section 704(c)(1)(B), if such property is distributed to another partner while there is still pre-contribution gain or loss allocated to it, the contributing partner recognizes such remaining gain or loss if such distribution takes place within seven years. Likewise, if a partner receives a distribution of appreciated property within seven years, while there is still unrecognized pre-contribution gain for that partner on other contributed property, under Section 737(b)(1), gain will be recognized up to the lesser of the remaining pre-contribution gain or the unrealized gain on that property.

EXAMPLE

Distribution of Pre-Contribution Gain Property

The Goldenrod Partnership was formed on April 17, 2014, by Joey, Monica, and Chandler each contributing $100,000 in cash. In addition, Chandler contributed land with a basis of $65,000 and an FMV of $100,000. The partnership broke even for three years. Finally, Joey wanted out and on September 22, 2018, the partnership distributed the land to Joey in exchange for his partnership interest.

Since the property was distributed to another partner within seven years of the contribution of the property to the partnership and Chandler still had $35,000 in unrecognized pre-contribution gain, Chandler recognized $35,000 on the distribution of that property.

EXAMPLE

Distribution of Pre-Contribution Gain Property

Assume the same facts as in Example 16, except that the land consisted of three parcels. Two of the parcels had $10,000 of gain and the third parcel had a precontribution gain of $15,000. The first two parcels were sold in 2016. At that time, Chandler recognized $20,000 of pre- contribution gain. Accordingly, in 2018 when the third parcel was distributed to Joey, only $15,000 of pre-contribution gain remained. Thus, Chandler recognized $15,000 in gain upon the distribution of the property to Joey.

NOTES

Unit 5

Allocation of Income & Target Capital Accounts

LEARNING OBJECTIVES

- **Compute** partners' capital accounts under traditional income allocation systems.
- **Contrast** traditional allocations and waterfall allocations.
- **Prepare** allocations under a targeted capital account agreement.

Unlike corporations, either C or S, a partnership can make "special allocations" of any item of income, deduction, gain, loss, or credit. This chapter examines the rules dealing with partnership allocations from the point of view of a group of partners who wish to make non–pro rata or special allocations. Those are allocations to partners that are different from their strict ownership interest in the partnership. For example, a partner owning 10% of the partnership capital might be allocated 75% of the partnership's depreciation for the first five years of operation.

The mission of tax practitioners is to make sure the Internal Revenue Service (IRS) will respect such an allocation or reconfiguration as a valid allocation with "substantial economic effect." Such special allocations are common, and often necessary from an economic perspective, for large real estate and oil and gas ventures.

These types of allocations are rare in small partnerships, so most small limited liability companies (LLCs) or partnerships (LLPs) will probably not have them. However, as more deals become more complicated, partnerships are reexamining their agreements and how partnership income or deductions should be allocated. Thus, practitioners are seeing more of these specialized allocations.

One of the underlying concepts of partnership taxation is that a partnership is but an aggregation of individual partners rather than an entity itself. The bulk of tax law for partnerships, contained in Subchapter K of the Internal Revenue Code, is based on this premise.

A partnership is not a taxpaying entity; it is a "pass-through" entity from which items of income, deduction, gain, loss, and credit are transferred to partners. Such tax attributes typically retain the same character in the hands of the partner as they had in the hands of the partnership (ordinary, capital, etc.).

A method must exist, therefore, to allocate such items of income, deduction, gain, loss, and credit among the partners. Absent restrictions, taxpayers have been, and continue to be, sufficiently aggressive and astute as to structure partnership operations and the allocations therefrom in a manner that will yield the best after-tax results for the partners.

Sometimes these "special allocations" work to the detriment of other partners; more frequently though, such allocations work to the detriment of government coffers. The rules under Section 704(b), therefore, were adopted to ensure that the interests of all partners, as well as the government, are protected.

The rules do this by requiring allocations to have substantial economic effect. Where there is a special allocation of taxable income, loss, deduction, et cetera, the economic benefits or burdens of that allocation must follow the tax allocation. Where one or more partners are in the same economic position before and after a special tax allocation, it's highly likely that the allocation has no economic effect and won't be respected by the IRS.

Consider a simple example to demonstrate the lack of substantial economic effect.

EXAMPLE

Special Allocation to a Partner

Two individuals, Jo and Deb, form a partnership. Except for a special allocation of all depreciation to Jo, Jo and Deb will be equal partners sharing all profits and losses 50/50. Upon termination, liquidating distributions will be made 50/50.

Jo and Deb each contribute cash of $40,000. With the cash, the partnership purchases a building for $80,000. The rental expense exactly equals rental income, so cash flow is net zero. At the point when depreciation claimed is $20,000, the partnership sells the building for its net book value of $60,000. Cash is distributed and the partnership is liquidated.

Observe what happens to the capital accounts:

	Jo	Deb
Initial Contribution	$40,000	$40,000
Depreciation	–20,000	0
Gain	0	0
Balance	20,000	40,000
Liquidation	–30,000	–30,000
Capital loss (gain)	($10,000)	($10,000)

Notice that Jo has a $10,000 capital gain while Deb has a $10,000 capital loss. Jo received the benefit of a $20,000 ordinary deduction. If the depreciation allocation had substantial economic effect, $10,000 of depreciation would have been allocated equally to each partner, the capital accounts would have each been $30,000, and there would have been no capital gain or loss on liquidation.

To provide that liquidating distributions will be made on a percentage ownership, noncapital account balances will cause the special allocation to lack economic effect. Thus, the allocation of depreciation in the previous example lacks substantial economic effect. By the way, the partner that is allocated the depreciation must also be allocated the recapture!

Background of the 704(b) Regulations

Prior to the Tax Reform Act of 1976, virtually any partnership allocation was permitted so long as the primary purpose of the allocation was not tax evasion or avoidance. Therefore, allocations could and would be made that did not reflect the underlying economics of the partnership arrangement even though such allocations were not made for tax evasion or avoidance.

The Tax Reform Act of 1976 required that partnership allocations have substantial economic effect in order to be recognized by the Service. On December 31, 1985, the Treasury published final regulations under IRC Section 704(b), implementing these changes. The Committee Reports indicate that the underlying goal of the changes was to remove the subjectivity inherent in the tax avoidance test of old IRC Section 704(b) by adopting "substantial economic effect" as the sole test for determining the validity of partnership allocations.

On September 9, 1986, additional regulations were issued regarding allocations attributable to nonrecourse debt. These final regulations also contain corrective and clarifying changes to the final regulations that were published in December 1985. The regulations consist of a lengthy text and numerous examples that provide complex rules for determining whether a partnership allocation will be respected and, if not, how such allocation must be reallocated among the partners. These rules regarding nonrecourse debt were subsequently modified in December 1988.

Some of the concepts established by the regulations are not models of objectivity. They do, however, demonstrate the Service's continuing concern with special allocations and the increasing sophistication of tax shelter transactions developed since 1976.

IRC Section 704(b) is disarmingly simple. It states the following:

A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

1. The partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

2. The allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Treasury regulations address substantial economic effect.

OVERVIEW OF THE REGULATIONS

The regulations (Reg. Section 1.704-1(b)(1)) provide that an allocation contained in a partnership agreement will be respected if it meets any one of the following tests:

- The allocation has substantial economic effect
- The allocation is in accordance with the partners' interest in the partnership
- The allocation is deemed to be in accordance with the partners' interests in the partnership

Whether an allocation has substantial economic effect under the regulations involves a two-part analysis that is made as of the end of the partnership year to which the allocation relates (Reg. Section 1.704-1(b)(2)). First, the allocation must have economic effect. Second, that economic effect must be substantial.

The first test for economic effect is a mechanical test with three requirements. However, in order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden (Reg. Section 1.704-1(b)(2)(ii)).

The bottom line is that the allocation must, ultimately, hit the partner to whom the allocation is made right in the pocketbook. There must be a financial (cash) impact on the partner.

The second part of the substantial economic effect analysis requires the economic effect to be substantial. The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts to be received by a partner, independent of tax consequences.

The substantiality analysis is a subjective test that has the potential to become a source of controversy and confusion. Nevertheless, the substantial economic effect test should generally be viewed as a safe harbor for the more subjective "partners' interests in the partnership" test.

Reallocation in accordance with the partners' interest in the partnership is the Service's offensive play, which puts the partners on the defensive. It creates a facts-and-circumstances analysis, which generally gives the taxing agency (that was not a party to the original agreement) a chance to argue that a better allocation (generally meaning one with more tax being paid) is a more appropriate reflection of economic reality.

As we will discuss, meeting the "economic effect" test is going to require someone to take care of the unusual thing that is referred to in the regulations as "book" capital—something with only a tenuous relationship to tax basis or GAAP capital accounts. Another requirement that we will discuss is that this "book capital account" must be used to liquidate the partners' interests, which means it determines who gets the cash in the end.

If the parties forming the partnership and their counsel drafted the agreement to provide safe harbor protection for the allocation (which is normally the case), the tax adviser needs to ensure that the accounting steps necessary to qualify for the economic effect test take place. If that does not happen, the allocations reported on the K-1 are open for IRS challenge and it is very likely that the wrong amounts will be distributed to partners in a liquidation.

Since the liquidation is a zero-sum situation, getting it wrong by definition will mean some party will end up with less than he should have—and that party will not likely be happy about that result if he later has this pointed out. That aggrieved party may very well look to recover the shortfall from the accountant that failed to inform the parties that they were failing to properly track information necessary for the partnership.

ECONOMIC EFFECT

In General

An allocation will have economic effect if the partnership agreement provides (the three-part mechanical test mentioned earlier) that (Reg. Section 1.704-1(b)(2)(ii)(b)):

- partners' capital accounts will be maintained in accordance with the detailed rules in the regulations (Reg. Section 1.704-1(b)(2)(iv));
- liquidating distributions will be made in accordance with the partners' positive capital account balances (Reg. Section 1.704-1(b)(2)(ii)(g)); and
- any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (Reg. Section 1.704-1(b)(2)(ii)(c)).

Allocations made by a partnership agreement that fails to contain all three of the listed requirements (sometimes knows as the "Big Three") can nonetheless have at least partial economic effect under the alternate test for economic effect if the only deficiency is that they do not require deficit restoration (though it comes with strings).

For purposes of Section 704(b), a partnership agreement embodies all of the agreements made by the partners. It can be written or oral, formal or informal (Reg. Section 1.704-1(b)(2)(ii)(h)).

Capital Account Maintenance Rules

The regulations provide the manner in which the capital accounts are to be maintained. The capital account is the partnership account representing the interest of the partner. When an interest is transferred, the transferee assumes some or all of the capital account of the transferor. Many partnerships maintain various accounts, such as "income accounts" and "drawing accounts," which are closed into the capital account at year-end. It is the capital account that is maintained for economic effect. Code Section 704 does not mention capital accounts. All of the rules are provided by the regulations.

Note that these capital account provisions are maintained on the "book basis," which is an economic basis, using fair market value (FMV) as the measuring method. This should not be confused with the accounting concept of "book value," which is cost less depreciation, et cetera.

The regulations bear no relationship to what most accountants would consider "book," which would be based on generally accepted accounting principles. Similarly, "book capital" is not the same as "tax basis" capital, despite the fact that both are tax concepts. Tax basis accounting controls the calculation of income for reporting on the tax return and it may be very different from "704(b) book" basis.

The term "book" for these purposes is purely the method of accounting for capital described in these regulations. This basis of accounting may be best viewed as a (somewhat inconsistent) fair value method of accounting.

Calculation of "Book" Capital Account

A partner's capital account is increased by:

- the amount of money contributed by the partner, and
- the FMV of the property contributed to the partnership by the partner, net of any liabilities encumbering the property that the partnership assumes or is subject to, and allocations to the partner of items of partnership income and gain, including tax exempt.

A partner's capital account is decreased by:

- the amount of money distributed by the partnership to the partner;
- the FMV of property distributed to the partner, net of any liabilities that the distributee partner assumes or takes subject to; and
- allocations of partnership items of loss and deduction and partnership expenditures that are neither deductible by the partnership in determining its taxable income nor properly chargeable to the capital account.

These items are reflected by the treatment at the partnership level and not affected by any elective or required treatment at the partner level. If a partner contributes its own promissory note to the partnership, its capital account will not be affected until the partnership disposes of the note in a taxable transaction or the partner makes principal payments. Likewise, the distribution to a partner of a partnership nonnegotiable note will not cause a decrease to the capital account until payment or other disposition.

However, if the interest of the partner is liquidated, its capital account will be decreased by the sum of (1) the FMV of any negotiable note distributed at liquidation and (2) the FMV of the outstanding portion of any such note that was previously distributed. For this purpose, if the note bears a market rate of interest, the FMV will be at least the unpaid principal balance.

Distributions of Property

When property is distributed, the partners' capital accounts must be adjusted to reflect the manner in which the gain or loss not previously reflected would have been allocated had the property been disposed of at FMV in a taxable transaction.

EXAMPLE

Property Distributions

Larry and Nick form Larnik Partnership by each contributing cash of $100. The partnership agreement provides that all items are to be shared equally. The agreement provides for the "Big Three." The partnership purchases two parcels of real estate at a cost of $100 each. Each property appreciates in value to $200. The partnership distributes one parcel to both Larry and Nick as tenants in common. Prior to this, each had a capital account of $100. Therefore, each will have a $50 adjustment for the applicable share of the gain that would have been recognized had the property been sold at FMV in a taxable transaction.

The rule that FMV must be at least equal to the amount of nonrecourse debt on the property is not applicable here or on contribution; however, it is applicable in determining the amount of gain or loss to be reflected.

Revaluations: FMV (A.K.A. the Partnership Freeze) (Reg. Section 1.704-1(b)(2)(iv)(f))

A partnership agreement may provide that the partners may adjust the capital accounts to reflect the revaluation of partnership property if the adjustment is made for a substantial nontax business reason in connection with:

- a contribution of money or property to the partnership by a new or existing partner in exchange for an interest;
- the liquidation of the partnership or the distribution of money or property in exchange for an interest in the partnership, whether retiring or continuing (partial), or if substantially all of the partnership's assets consist of stocks, securities commodities, or similar instruments that are readily tradable on an established exchange and such revaluation is made in accordance with generally accepted industry accounting practices; or
- the award of a taxable profits interest to a partner.

In these situations, where assets have already appreciated, the question often arises regarding who will pay the tax on the gain when the assets are sold. This is especially important because the contribution to a partnership for an interest in the partnership does not give rise to a basis adjustment under Section 743 of the code.

Partners may therefore agree to a partnership freeze (a recapitalization) to specifically allocate the gain inherent in partnership assets before the admission of a partner. To accomplish this, the partnership determines the fair market of its assets prior to the admission of the new partner and creates a balance sheet at FMV. The capital accounts will be adjusted up for the old partners to reflect this new FMV, and the newly admitted partner will be shown equal to the amount she contributed.

This new balance sheet will run parallel to the old balance sheet for the life of the partnership. It will be adjusted up and down for activity of the partnership just as the old balance sheet will. The purpose of this new balance sheet will be to determine the allocation of any gain or loss on the disposition of assets held prior to the admission of the new partner.

If an asset that was held prior to the admission of the new partner is sold, the gain is calculated based on both balance sheets. The old balance sheet will determine the total amount of tax gain to be taxed. The new balance sheet will be used to determine how much will be allocated to the old partners versus the new partner.

The same basic principles discussed earlier for a Section 704(c) allocation of pre-existing gain or loss to a contributing partner apply here, except now it is the "old" partners who have effectively "contributed" assets with a tax basis that does not agree with the fair value. In fact, these rules are often referred to as generating "reverse Section 704(c)" allocations.

EXAMPLE

Partnership Recapitalization

On January 1, 2013, Crabby Partnership has the following assets:

	Fair Market Value	Tax Basis
Cash	$0	$0
Building—Original Cost	90,000	40,000
Less Accumulated	0	–10,000
Total Assets	$90,000	$30,000
Liabilities	$9,000	$9,000
Capital Art	27,000	7,000
Capital Morgan	27,000	7,000
Capital Charles	27,000	7,000
Total Liabilities and Capital	$90,000	$30,000

Doug is then admitted to the partnership for a cash contribution of $9,900 for which he receives a 10% interest.

The recapitalized balance sheet looks like this:

	Recapitalized
Cash	$9,900
Building	90,000
Less: Accumulated Depreciation	0
Total Assets	$99,900
Liabilities	$9,000
Capital Art	27,000
Capital Morgan	27,000
Capital Charles	27,000
Capital Doug	9,900
Total Liabilities and Capital	$99,900

The partnership operates for five more years with zero taxable income (other than depreciation) so that only depreciation is considered for this example. In addition, the property has appreciated to $120,000.

Reg. Section 1.704-3 will generally require that Doug receive the depreciation that would be allocated to him had the partnership had a $90,000 tax basis in the building to depreciate (referred to as a reverse 704(c) allocation). In this example, assume that the depreciation over the five-year period was $2,500 and that it was all allocated to Doug.

Just prior to the sale of the building, the balance sheets look like this:

	Fair Market Value	Recapitalized Basis	Old Tax Basis
Cash	$9,900	$9,900	$9,900
Building	120,000	90,000	40,000
Less Accum. Depr.	0	0	–12,500
Total Assets	$129,900	$99,900	$37,400
Liabilities		$9,000	$9,000
Capital Art		27,000	7,000
Capital Morgan		27,000	7,000
Capital Charles		27,000	7,000
Capital Doug		$9,900	$7,400
Total Liabilities and Capital		$99,900	$37,400

When the building is sold, step one is to determine the total amount of gain to be recognized. The total amount of gain is $92,500 ($120,000 – $27,500).

The next step is to allocate the gain up to the recapitalized basis to the old partners (Art, Morgan, and Charles). The sales price is greater than the recapitalized basis of the building of $90,000.

Therefore, the first $62,500 would normally be allocated to Art, Morgan, and Charles. However, since the depreciation has been allocated strictly to Doug under Reg. Section 1.704-3(a)(1), all of the gain caused by the additional depreciation taken by Doug since his admittance to the partnership will be allocated to him. Therefore, the gain allocated to Art, Morgan, and Charles will be $60,000 ($90,000 – the net basis of $30,000 at the time of D's entry into the partnership). This would be allocated 1/3 to each of them.

Since Doug has received the depreciation on the asset for the last five years, he would be allocated the gain caused by that depreciation ($2,500).

Now the remaining gain of $30,000 would be allocated to the entire group in accordance with their interest in profits of the partnership (30%-30%-30%-10%). Under this example, Art would receive an additional $9,000 gain, as would Morgan and Charles, and a $3,000 gain would be allocated to Doug.

The allocation of the entire gain would be as follows:

Art	$20,000 + $9,000 =	$29,000
Morgan	$20,000 + $9,000 =	$29,000
Charles	$20,000 + $9,000 =	$29,000
Doug	$2,500 + $3,000 =	$5,500
Total Gain		$92,500

Double Check

As a double check, look at the capital accounts of the partners and see what happens upon liquidation of the partnership.

	Art	Morgan	Charles	Doug	Total
Beginning Capital	$7,000	$7,000	$7,000	$0	$21,000
Doug joins partnership	0	0	0	9,900	9,900
Depreciation for 5 years	0	0	0	-2,500	-2,500
Gain on Sale	29,000	29,000	29,000	5,500	92,500
Subtotal	$36,000	$36,000	$36,000	$12,900	$120,900
Liquidation proceeds ($129,900 cash – $9,000 liabilities)	−36,000	−36,000	−36,000	−12,900	−120,900
Ending capital accounts	$0	$0	$0	$0	$0

Analysis of Overall Transaction

Overall, Art, Morgan, and Charles paid tax on the gain inherent in the building at the time they admitted Doug, plus 90% of the appreciation after admitting Doug. They also received cash upon liquidation accordingly. Doug reported depreciation deductions of $2,500 and gain (according to the depreciation of $2,500) plus $3,000 additional gain—10% of the gain after he joined the partnership (($120,000 – $90,000) × 10%). He also received his investment back in cash of $9,900 plus his share of the appreciation after joining the partnership ($3,000). Therefore, the transaction had substantial economic effect.

Oil & Gas

Because the depletion on oil and gas properties is taken at the partner level, the book capital accounts are adjusted for simulated depletion and gain or loss on such properties.

Deficit Restoration Obligation

One of the three requirements that a partnership must meet to create substantial economic effect is the requirement that any partner with a deficit capital account (on the FMV or book basis) must make a cash contribution to the partnership on liquidation to bring that account to zero. Known as the deficit restoration obligation (DRO), this requirement imposes an economic penalty on partners and can create unexpected liabilities for partners.

Partnerships with a DRO in the agreement should be certain that the partners understand the impact of the provision and the liability it will create. Quite often advisers will find, especially for partnerships using LLC structures meant to limit liability, which the partners will prefer to avoid having such a clause in the partnership agreement, at which point the agreement will need to look to the alternative economic effect test to obtain safe harbor protection for allocations.

The question of whether a DRO creates at-risk was answered by the Tax Court in *Hubert Enterprises v. Commissioner*, T.C. Memo 2008-46. On remand from the 6th Circuit, the Tax Court concluded that a DRO didn't create at-risk basis because the LLC member wasn't personally liable for the debt since the obligation wouldn't necessarily arise. If there was a default on the LLC debt, the member wasn't immediately liable for the debt. The member's interest would first have to be liquidated. Additionally, the DRO only required the payment of the deficit in the member's capital account, not a percentage of the debt.

Alternate Economic Effect (AEE) (Reg. Section 1.704-1(b)(2)(ii)(d))

A partnership agreement that fails to contain each of the three requirements listed earlier may still have at least partial economic effect (Reg. Section 1.704-1(b)(2)(ii)(e)). To meet the test for alternative economic effect, the first two of the listed requirements for economic effect must be met by the partnership agreement. That is, the partnership agreement must still require that the capital accounts be maintained in accordance with the regulations and liquidations be made only in accordance with positive capital accounts.

Qualified Income Offsets & Alternate Economic Effect

In place of a DRO, the partnership agreement must contain a qualified income offset (QIO). A QIO operates to restore any unexpected reduction in a partner's capital account. "Unexpected" is the operative word. Expected reductions are to be accounted for as discussed later, generally with the partnership agreement simply operating to cease negative allocations to a partner if those allocations would drive that partner's capital account to a deficit balance.

The idea generally is that the problem of the DRO is avoided by simply assuring that allocations of loss and distributions stop under the agreement if a partner exhausts her book capital.

However, sometimes events outside the norm will occur that cause the capital account to go negative. Partners could cover this eventuality by agreeing to restore the negative account, but quite often they don't want to be on the hook for such an event, even if unlikely. So, the QIO rules allow for an alternative fix to such unexpected events that drive the capital account below zero.

In determining AEE, hypothetical capital accounts are created with the beginning balances being the known, actual capital account balances. All expected adjustments to the capital accounts, other than the allocation being tested, are entered for the year in question. The expected (albeit hypothetical) capital account balances, without consideration of the allocation being tested, are then determined.

A critical requirement of a QIO is that adjustments must be made to a partner's capital account before allocating any losses.

The adjustments must be made, to the extent that they are reasonably expected to occur in the current or future years, for the following items:

- Allocations of deductions and losses under the family partnership rules
- Certain oil and gas percentage depletion deductions
- Tax loss allocations as a result of the distribution of unrealized receivables
- Allocation of cash basis items under IRC Section 706(d) when a partner's interest changes. Distributions in excess of any increase in a partner's capital account during the year

To the extent that an allocation of one or more of the other items creates a negative book capital account, no further economic loss allocations can be made. Thus, as noted earlier, if the capital accounts have not been maintained properly, allocations of economic loss may made to a partner who should not have received the allocation. Since partnership income allocations are a zero-sum situation, which will also mean that some partner failed to be properly allocated losses.

The QIO rules provide that if an unexpected allocation of one or more of the listed items creates a negative capital account, an offsetting allocation of gross income or gain must be made to that partner. The offsetting allocation must be sufficient to eliminate the deficit as quickly as possible.

Reconsider the first example with an additional year's depreciation.

EXAMPLE

Partnership Recapitalization (Continued)

The facts are the same as in the first example. Depreciation in year 2 is $25,000. The property is sold for net book value at the end of the second year.

Observe what happens to the capital accounts.

	Jo	Deb
Initial Contribution	$40,000	$40,000
Depreciation Year 1	–20,000	0
Balance Year 1	20,000	40,000
Depreciation Year 2	–25,000	0
Gain	0	0
Balance	–5,000	40,000
Liquidation	–17,500	–17,500
Capital loss (gain)	–$22,500	$22,500

Again, the allocation does not have economic effect. If the partnership agreement contained the requirements for capital account maintenance, liquidation in accordance with positive capital accounts, and a qualified income offset provision, this arrangement could have full economic effect in year 1 and partial economic effect to Jo in year 2.

Observe what happens to the capital accounts with a compliant allocation structure.

	Jo	Deb
Initial Contribution	$40,000	$40,000
Depreciation Year 1	–20,000	0
Balance Year 1	20,000	40,000
Depreciation Year 2	–20,000	–5,000
Gain	0	0
Balance	0	35,000
Liquidation	0	–35,000
Capital loss (gain)	$0	$0

In year 1, the special allocation of depreciation to Jo did not cause or increase a deficit in her capital account. Since the partnership contains the first two requirements for economic effect plus a QIO, the allocation has alternative economic effect in year 1.

In year 2, the allocation has partial economic effect under the AEE test to the extent of $20,000. The remaining $5,000 of the depreciation is reallocated to Deb. With liquidation in accordance with positive capital account balances, Deb receives $35,000. Thus, Deb recovered her investment through cash plus depreciation. Jo's investment was recovered through a depreciation allocation only.

The QIO cannot offset expected capital account reductions. The QIO, therefore, does not operate to give Jo restoration to permit allocation of the additional $5,000 of depreciation. A qualified income offset provision must provide that a partner who unexpectedly receives a charge that creates or increases a deficit balance

in that partner's capital account will be allocated items of income and gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.

Items That Trigger a Qualified Income Offset

If a QIO is triggered, it will most likely be by the distribution of cash to partners upon the refinancing of partnership property. If a partner's book capital account is zero, the QIO rules prohibit the allocation of book losses (and the corresponding tax losses) to partners for whom the losses would cause their book capital account to become negative.

If a partner's book capital account becomes negative in a partnership with a QIO, the partnership must allocate gross income and gain to that partner to eliminate the negative book capital account. This obviously means that other partners will get allocations of gross deductions or losses. However, at the end of the day, the QIO is designed to bring the book capital accounts back into line with what would happen if the assets were sold for book value and the partnership liquidated.

Economic Effect Equivalence (Reg. Section 1.704-1(b)(2)(ii)(I))

Allocations under a partnership agreement that does not contain the three requirements for economic effect and does not contain the three requirements for alternative effect may nonetheless have economic effect. If, at the end of each partnership year, a liquidation of the partnership would produce the same economic results to the partners as would occur if the three requirements were met, regardless of the economic performance of the partnership, allocations would be reconsidered to have economic effect. This has been referred to as the "dumb but lucky" rule.

EXAMPLE

Lucky Allocations

Jo and Deb contribute $75,000 and $25,000, respectively, to a general partnership. The partnership agreement provides that all items of income, deduction, gain, loss, or credit will be split 75/25 between Jo and Deb. Liquidation distributions will likewise be made 75/25. The partnership agreement contains no provisions regarding capital account maintenance, liquidation in accordance with capital account balances, or deficit makeup.

Lacking provisions regarding capital account maintenance, liquidation in accordance with capital account balances, or deficit makeup, the agreement regarding allocation of income, deduction, gain, loss, or credit cannot have economic effect under Reg. Section 1.704- 1(b)(b)(2)(ii)(b). The allocations will be recognized, however, under the economic effect equivalence test of Reg. Section 1.704-1(b)(2)(ii)(I).

While this is known as "being lucky," this rule does have other uses. For instance, this provides a fallback position to support allocation systems that may not literally follow the economic effect provisions—such as the "waterfall allocations" found in target capital account structures.

SUBSTANTIALITY

The following references to "(See Example ())" are for comprehensive examples listed in Reg. Section 1.704-1(b)(5) illustrating the operation of the "704(b) regulations."

Achieving economic effect is only part of the answer. In order to be recognized, the economic effect of an allocation must be substantial (Reg. Section 1.704-1(b)(2)(iii)).

The economic effect of an allocation is not substantial if it merely shifts tax consequences and the changes recorded in the partners' capital accounts do not differ substantially from the change that would have been recorded in the partners' capital accounts without the allocation (Reg. Section 1.704- 1(b)(2)(iii)(b)). Additionally, the economic effect of an allocation is not substantial if there is a strong likelihood that the allocation will be offset by other allocations and the total tax liability of the partners will be less as a result of the allocation (Reg. Section 1.7041(b)(2)(iii)(c)).

The test for substantiality is an after-tax concept. The tax consequences of transactions outside the partnership must be taken into account. Generally, the test may be encapsulated by the following rules. The economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement:

- the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and

- there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.

Reg. Section 1.704-1(d) makes it clear that where a partner is a look-through entity (i.e., a partnership, S corporation, trust, etc.), the tax consequences to the ultimate owner must be considered in determining whether there is substantiality to a tax allocation.

The bottom line is that an allocation fails the substantiality test if its effect is to benefit one or more partners after taxes and not to adversely affect any other partner.

What is being tested is the difference between the special allocation and what would have been allocated under the partnership agreement had the special allocation not been present. This may not be as easy as it seems. Many service partnerships make allocations retroactively after year-end when they know how the results for the year. It then requires unstated assumptions to identify what the hypothetical agreement allocation would have been in order to apply the test.

Shifting Allocations

Allocations within one taxable year that reduce the overall tax liability of the aggregate partners but have no significant economic effect are invalid. An allocation is a shifting allocation if, when made a part of the partnership agreement, there is a strong likelihood that:

- the net increases and decreases that will be recorded in the capital accounts for the year will not differ substantially from the net increases and decreases that would be recorded for such year if the allocations were not there, and

- the total tax liability of the partners after the allocation will be less than if it was not in the agreement (considering non-partnership items such as Section 469).

Basically, if the only likely "loser" under the allocation in question is the U.S. Treasury, the allocation won't be respected.

The shifting rule is demonstrated by examples in the regulations at Section 1.704-1. If an allocation affects more than a one-year period, the regulations test it under the transitory rule described following this explanation.

EXAMPLE

Shifting Tax Allocations

Shannon and Emma are partners in the Shifty Partnership, formed many years ago. Shannon and Emma have always split the income evenly. In 2013, Shifty had $100,000 of passive income and $90,000 of tax-exempt income. Shannon had over $200,000 of passive losses he couldn't use, except to offset his share of Shifty's passive income. Shannon and Emma decided that for 2013 Shannon would be allocated all of the passive income and Emma would get the tax-exempt income.

No change was made to the consequences of the allocation on liquidation and the partners anticipated no changes in the equal allocations in future years. Both partners were in the 35% tax bracket.

Here, the question is whether the allocation is substantial. To determine that, the consequences of the special allocation must be compared to the consequences if the special allocation hadn't been made. Had the allocation not been made, the following would be the partners' tax and economic consequences for 2013:

	Shannon	Emma
Passive Income	$50,000	$50,000
Tax-Exempt Income	45,000	45,000
Less Passive Losses	–50,000	0
Less Income Tax	0	–17,500
Net Cash after Tax	$95,000	$77,500

Since both Shannon and Emma are better off with the special allocation, after tax considerations, the allocation is not substantial and will not be recognized by the IRS.

Transitory Allocations

If the economic effect will be offset by an allocation in a later year, it is transitory. If the allocations are combined and the net effect is to reduce the tax liability of the partners, and at the time the allocations become part of the agreement there is a strong likelihood that (1) the net increases and decreases recorded in the partners' capital accounts for the taxable years will not differ substantially from the net increases and decreases that would be recorded for such years if the original allocation and offsetting allocation were not there, and (2) the total tax liability of the partners will be less than had the allocations not been part of the agreement (considering the partners non partnership tax items), then there's a problem.

If the allocations have the result in (1), then there is a rebuttable presumption that there was a "strong likelihood" of a transitory allocation when agreed to by the partners.

Not all allocations that have this effect will be transitory. For example, allocations of loss that are offset by future gain allocation from the sale of assets may not be transitory because of the value equals basis rule—the rule mandates that the future value will be assumed to be its basis or book value (see Example (1)(ix)). Likewise, if the second allocation is mandatory under the five- or seven-year rules under Section 704, then they are not considered to be transitory. In addition, if it can be

shown that the venture was speculative and risky when entered into, it will not be transitory because the future profits are speculative (see Example (3)).

One area of conflict is property that is subject to cost recovery or other reduction in basis. Later, for testing purposes, it will not generate income since value equals basis. This assumes that the economic burden of cost recovery is real and ignores the reality that once depreciated, the property still has value. For example, the property may continue to generate income from leasing. The regulations sanction a gain chargeback, but there is a problem with income offsets. Regulations will allow gain but not income offsets if the property is subject to a long-term lease.

The regulations provide that offsetting allocations under the value equals basis rule will not be transitory if they do not arise for more than five years (see Example (2)).

EXAMPLE

Transitory Allocation

Homer and Marge are equal partners in the Nuclear Partnership. Homer has a large NOL that will expire in 2010. Nuclear's earnings have been pretty consistent, with about $300,000 in ordinary rental income and $300,000 in tax-exempt income. Nuclear Partnership has allocated everything equally over the years. In 2009, Homer and Marge agree that Homer will get all the ordinary income and Marge will get the exempt income. In the following year or years, Marge will be allocated the taxable income until her allocation equals $300,000. Likewise, Homer will be allocated the exempt income until his allocation equals $300,000. This allocation won't be respected because over a very short period of time, the partners will return to equal allocations of all items, with the only benefit being the tax savings created by the special allocation.

Overall Effect

Finally, going back to the basic thrust of the regulations, a special allocation must pass the "overall effect" test; the economic effect may significantly affect the partners' capital accounts and still not be substantial if the after-tax effect is that no partner will be in a worse economic situation than without the allocation.

Generally, this will only occur if the partners have significant non-partnership tax attributes that influence their special allocations (see Examples 5 and 6). The test looks at the present value of the various effects.

Since credits (and recapture) do not adjust the capital accounts (except any required basis adjustments), they cannot have economic effect and must be allocated in accordance with the partner's interest in the partnership.

TARGET CAPITAL ACCOUNTS

The regulations and most accountants look at partnerships as driven by annual allocations of income per various rules, with a capital account simply being the result of those detailed allocations. That view of capital accounts continues for the entire life of the partnership, including governing the final distributions to the partners when the partnership disposes of its assets and wraps up operations.

However, many partnerships are designed with their eventual demise in sight when established, especially in real estate. The life cycle of most real estate investments looks at the acquisition of the

property, a period of operation (be that development or rental), and then an eventual sale of the property. A major reason for this view is that a large portion of the return on real estate comes from appreciation of the property. Even in development projects, equity holders pick and choose which projects to personally invest in rather than necessarily wanting to go along with an entity that will continue to select, acquire, and develop new properties.

In such a partnership, the most important part of the underlying economic structure relates to how proceeds will be distributed when the property is finally disposed of and the assets (normally cash) are distributed to each equity holder. In such a case, the deal will often be stated in terms of that eventual final distribution.

The terms discussed by the parties that will form the partnership may be something like this.

EXAMPLE

Harry has identified an office building he believes is undervalued on the market at $1,050,000 and that will appreciate greatly over the next five years. Harry has almost all of his assets tied up in other real estate projects now, so while he has substantial net worth, he has little current available free cash. He approaches Marty and Wayne about coming together with him to acquire the building. Harry will put in $100,000, will manage the project—including rental issues and eventual sale of property when he judges it best based on his knowledge of the market— and he agrees to be solely liable for guaranteeing the mortgage. Marty and Wayne will each put in $350,000.

They agree that any excess cash generated during the rental period will go first to pay down the mortgage principal. Distributions will be in the following order:

- Distributions will first be made in equal amounts to Marty and Wayne until they receive back their original contributions.
- The next distributions will go to Harry until he is paid back his original contributions.
- The third-tier distributions will go to each member to give the member a 6% annual return on the capital they have invested, taking into account any amounts previously returned under a first- or second-tier distribution as reducing their invested capital.
- The fourth-tier distributions will compensate Harry at $10,000 per year the building is held for his management work, as well as his expertise in originally selecting the property.
- Finally, any additional distributions will go 33% to each partner.

While that arrangement makes perfect sense to the partners, attempting to devise an allocation of income, gains, deductions, and losses so that the resulting capital accounts will be in line with that final distribution in all circumstances is, at best, challenging. While it’s not terribly difficult to make this work if everything goes as expected (the property appreciates in value and is sold for a large gain in five years), designing the allocation to still come to this result in any potential future set of events is often nearly impossible.

Concept of a Targeted Capital Account

What the noted agreement describes is not an allocation of income, but the final result that should be reflected in the partnership’s capital account. Since that is what the partners want, the argument goes that rather than designing an incredibly complex set of allocations that we have to test under every possible circumstance to ensure we get that capital account, why not simply define the capital

account in accordance with those rules, assuming all assets are sold at year-end for their tax bases and then make the "backed into" item the allocations that will achieve that goal?

The advantages of the targeted capital accounts are generally outlined as follows:

- No need to maintain book capital accounts. Quite often in real life, a partnership doesn't end up keeping a separate calculation of Section 704(b) capital accounts. With a targeted capital account, the capital account isn't derived from allocations and other special rules; it simply can be computed based on the agreement and the partnership's tax basis books.

- Simpler partnership agreements. Quite often, the allocation provisions of a partnership agreement drafted from an allocation first perspective are incredibly complex and difficult for even trained accountants and tax attorneys to follow. The partners themselves have little hope of understanding those allocations, and rather just hope they end up with the result the parties want when the partnership makes its final distributions.

- Agreement will produce the result the partners want. When traditional agreements hit situations that weren't anticipated and allocations end up creating liquidation payments at odds with what the parties expected, partners who feel shorted often go looking for someone to make them whole— and quite often that will be the professionals who, in the partners' view, failed them. A target capital account agreement is defined fully in terms of that final distribution, rather than having a complex system of allocations we hope will end up with the expected result.

So, if they are so wonderful, why haven't we had all agreements written this way?

- Not clear if IRS will respect allocations. Critics complain that the regulations that govern special allocations don't treat the allocation as a "to be derived" afterthought of the capital account, raising the specter that the IRS could challenge the allocations on exam. Often agreements do have clauses in them to "direct" allocations that attempt to use Section 704(b) regulation language and defenders note that even if they arguably fail the "economic effect" regulatory requirements, they either should be respected under the economic effect equivalence provision found at Reg. Section 1.704-1(b)(2)(ii)(I) or be arguably in line with the partner's interest in the partnership under Reg. Section 1.704-1(b)(3).

- Can result in unexpected allocations on a K-1. Because the target needs to be obtained, the allocations must be forced to obtain that result. That can result in a particular partner being allocated income in a year in which the partnership has a net loss. While understanding a complex allocation structure is difficult for a partner to follow, it's also tough for the partner to accept that he has to report income when the partnership had a net loss for the year. Even if not so extreme, there may still be what will be viewed as difficult to explain differences in partners' K-1s due to the need to bring capital accounts in line with the target account numbers.

Computing Allocations under a Target Capital Account Agreement

The first step in a targeted capital account allocation is to start with the capital accounts from the prior year. Next, the accountant takes into account any capital contributions and distributions to obtain a partner's capital account before the allocations for the current year are made.

The accountant next presumes that all assets of the partnership are sold for their tax bases and converted to cash, with the partnership looking to prepare liquidating distributions. Using that theoretical pool of cash, the accountant computes the distribution that each partner would receive under the terms of the partnership agreement. That deemed distribution would be the positive capital account for partners who would receive a distribution. If a partner would be required to contribute additional funds under the agreement in this theoretical liquidation, that partner would have a negative ending capital account.

The items of income, gains, deductions and losses would be allocated, as necessary, to adjust the before-allocations capital account to agree with the computed target account.

The partnership agreement would normally contain provisions somewhat along the following lines:

> Net profits are first to be allocated to any partners with a negative capital account, in proportion to the partner's negative balances. Any remaining net profit or loss is to be allocated to each partner to create a capital account equal to the amounts that would be distributed under the terms of this agreement, presuming a sale of partnership assets for their tax bases.

EXAMPLE

Continuing with the previous example, assume the partnership has rental income in excess of expenses before depreciation of $75,000 and a depreciation expense of $20,000. The $75,000 represents net cash, which is used to pay down the mortgage.

The following is a summarized beginning and ending balance sheet, as well as activity for the year:

	Beginning of the Year	Activity	End of the Year
Cash	-		-
Building and Land	1,050,000		1,050,000
Accumulated Depreciation	-	25,000	25,000
Net Assets	1,050,000	(25,000)	1,025,000
Mortgage	250,000	(75,000)	175,000
Total Partner Capital (tax basis)	800,000	50,000	850,000
Total Liabilities and Equity	1,050,000	(25,000)	1,025,000

If the building was sold for $1,025,000, the first $175,000 would be used to pay off the mortgage, leaving $850,000 to distribute to the partners. Thus, the target capital accounts for each would be as follows:

	Total	Harry	Marty	Wayne
Cash Contributed	700,000	-	350,000	350,000
Cash Contributed for Harry	100,000	100,000	-	-
6% Return on Capital	48,000	6,000	21,000	21,000
Harry's Additional Return	2,000	2,000	-	-
Target Capital Account	850,000	108,000	371,000	371,000

The allocation for each would therefore be as outlined as follows:

	Total	Harry	Marty	Wayne
Beginning Capital	-	-	-	-
Contributions	$800,000	$100,000	$350,000	$350,000
Capital before Allocations	800,000	100,000	350,000	350,000
Allocation for Profit Necessary for Target Capital Account	50,000	8,000	21,000	21,000
Target Capital Account	850,000	108,000	371,000	371,000

There's nothing terribly surprising with that case, but if we change the example slightly, things are a bit different.

EXAMPLE

The agreement is modified so that the preferred return to Marty and Wayne is to be paid before Harry is paid back his capital contribution or receives any preferred return. Also, the partnership has income and cash flow before depreciation of only $30,000. In this case, the balance sheet looks like this:

	Beginning of the Year	Activity	End of the Year
Cash	-		-
Building and Land	1,050,000		1,050,000
Accumulated Depreciation	-	25,000	25,000
Net Assets	1,050,000	(25,000)	1,025,000
Mortgage	250,000	(30,000)	220,000
Total Partner Capital (tax basis)	800,000	5,000	805,000
Total Liabilities and Equity	1,050,000	(25,000)	1,025,000

The target capital account calculation to distribute the deemed $805,000 capital account is as follows:

	Total	Harry	Marty	Wayne
Cash Contributed	700,000	-	350,000	350,000
6% Return on Capital	42,000	-	21,000	21,000
Harry's Return of Capital	63,000	63,000	-	-
Harry's Additional Return	-	-	-	-
Target Capital Account	805,000	63,000	371,000	371,000

Note that while Marty and Wayne get back not only their original contribution along with their preferred return, Harry ends up with less than his original capital contribution. This means Harry needs a negative allocation (a loss) in order to get to his target capital account, and Marty and Wayne will need to be allocated $42,000 of income in total to get to their accounts.

This will require dividing up the income and deductions on the return differently to get to the proper capital accounts—and create a loss for Harry (where a net loss did not exist on the Form 1065) and more income going to Marty and Wayne than the net income shown on the Form 1065.

	Total	Harry	Marty	Wayne
Beginning Capital	-	-	-	-
Contributions	$800,000	$100,000	$350,000	$350,000
Capital before Allocations	800,000	100,000	350,000	350,000
Allocation for Profit Necessary for Target Capital Account	5,000	(37,000)	21,000	21,000
Target Capital Account	805,000	63,000	371,000	371,000

This illustrates an issue that CPAs need to address when such arrangements are proposed. At times, partners and even their counsel assume that target capital account structures solve all problems—but, again, the unexpected situations can lead to strange K-1s. A CPA involved when such structures are being designed should consider running a stress test on the agreement to show the partners the tax allocations that would occur under various scenarios.

Other Issues to Consider

Note that the targeted capital account deals with the Section 704(b) allocation issue only. Such partnerships will still need to deal with other issues, including the following.

- Any Section 704(c) allocations that may be required have to be dealt with. Recall that such allocations, while subject to recognition using any reasonable method, still must be dealt with by the partnership. Use of a target capital arrangement does not allow allocation of pre-contribution gain or loss in a special allocation to get around Section 704(c)'s provisions.

- The allocation rules related to minimum gain and depreciation recapture also must be respected by the partnership. Again, a target capital account structure does not allow the partnership to avoid such rules.

Use of Target Capital Accounts

The use of target capital accounts in agreements has been increasing, but the popularity varies by region. Most often, they have been seen in real estate partnerships and not as often in operating partnerships such as law firms and CPA firms. Their use makes less sense in such enterprises; there, the use of annual earnings and losses as a measurement to arrive at capital accounts makes more sense since there is not normally an expected liquidation, nor is appreciation of assets often a major source of return for the enterprise on which the partners are depending. In these cases, dividing up the annual earnings is almost always the far more contentious issue.

PARTNER'S INTEREST IN THE PARTNERSHIP

If an allocation fails to meet the substantial economic effect test, it may still be respected if it is in accordance with the partners' interests in the partnership (Reg. Section 1.704-1(b)(3)). The regulations state that the partners' interests in the partnership will be determined by taking into account all facts and circumstances. This is normally a dangerous position to rely on, since the IRS could easily contend that the partner's interest in the partnership is based upon weighting various facts differently than the client weighted them. As a practical matter, a partnership that allocates all items in accordance with the partner's ownership percentage will probably meet the "partner's interest in the partnership" test.

There are, however, special rules that deal with allocations that cannot have economic effect, including the following:

- Allocations of tax depreciation, depletion, amortization, and gain or loss with respect to partnership property when the book value of the property differs from the tax basis of such property
- Allocations of excess percentage depletion (Example 12 in the regulations)
- Allocations of the adjusted basis of oil and gas properties (Example 19 in the regulations and IRC Section 613A(c)(7)(D))
- Allocations of credit (Example 11 in the regulations)
- Allocations of tax losses and deductions attributable to nonrecourse debt (Reg. Section 1.704-2)

ALLOCATION OF DEDUCTIONS ATTRIBUTABLE TO NONRECOURSE DEBT

The prior discussion assumed that the partnership's activities were financed with recourse debt or the partners' own cash and property. Larger partnerships, particularly real estate, oil, and gas partnerships, finance their activities with nonrecourse debt. The economic risk of such partners is limited to the cash and property invested, plus any loans they may have guaranteed. Should the value of partnership property decline, the partners may simply walk away from the deal, leaving the creditor to bear the economic loss. This scenario is less common than it was twenty years ago, as nonrecourse lenders have become more cautious in these transactions.

Where a partner receives an allocation of a deduction that is attributable to nonrecourse debt, the economic burden corresponding to the deduction is borne solely by the creditor and the allocation

cannot have economic effect. Therefore, the item must be reallocated in accordance with the partner's interest in the partnership. The regulations under Section 704(b) provide that no allocation of deductions attributable to nonrecourse debt can have substantial economic effect.

However, the regulations provide a four-part safe harbor test so that allocations of nonrecourse deductions may be deemed to be made in accordance with the partner's interests in the partnership (see Reg. Sections 1.704-2(b)(1) and (e)). The tests revolve around the concept of the partnership's minimum gain. "Minimum gain" is the amount of gain that a partnership would realize if it disposed of each of its properties that is subject to a nonrecourse liability for no consideration other than the satisfaction of the debt.

In other words, it is the excess of the nonrecourse liability over the adjusted basis of the property securing the debt. Partnership minimum gain arises in two circumstances:

- When the adjusted basis of the encumbered property is reduced below the amount of the nonrecourse liability (i.e., through depreciation)
- When the amount of the nonrecourse liability is increased in excess of the adjusted basis of the property, perhaps when the property is refinanced

The deductions that give rise to partnership minimum gain are referred to as "nonrecourse deductions" and generally are depreciation deductions reducing the adjusted basis of the property below the amount of nonrecourse debt securing by the property.

When there is a decrease in a partner's share of minimum gain, something must be done to allocate gain to the partner and to make a corresponding increase in that partner's capital account.

Accordingly, the regulations require that for any tax year in which there is a net decrease in the partner's share of minimum gain, that partner must be allocated—by a provision in the partnership agreement know as a "minimum gain chargeback"—income and gain in an amount equal to the net decrease in the partner's share of minimum gain.

The event triggering a decrease in partnership minimum gain will often be the disposition of property subject to nonrecourse debt. Occasionally, a decrease in partnership minimum gain can also occur when the principal amount due on a nonrecourse liability is reduced or when a partnership liability is converted from nonrecourse to recourse.

There are four exceptions to the minimum gain chargeback rules.

- The debt is converted to recourse debt and the partner bears the economic risk of the obligation.
- A partner pays her share of the nonrecourse liability creating the minimum gain.
- The IRS issues any pronouncement providing an additional exception.
- The IRS waives the requirement because imposing a minimum gain chargeback would distort the underlying partner economic agreement.

ALLOCATIONS OF DEPRECIATION RECAPTURE

The Service was concerned that old partners who received the benefit of higher depreciation would be able to shift the ordinary income recapture potential to more recent partners. To avoid this, Reg. Section 1.1245-1(e)(2) provides that the partner's share of recapture income is the lesser of:

- the partner's share of the gain or
- the partner's share of depreciation and amortization from the property.

Any remaining recapture is allocated among the partners whose gain exceeds their share of recapture.

This applies a tax-benefit approach by ensuring that a partner recognizes recapture equal to what the partner had previously deducted in depreciation and amortization on that property.

If the property is subject to Section 704(c), the regulations provide that the contributing partner's share of depreciation and amortization includes the amount allowed before contribution to the partnership.

Because the curative and remedial methods for Section 704(c) reallocate the contributing partner's share of depreciation and amortization, the total depreciation and amortization recapture may exceed the amount of recapture at the partnership level. In that case, the partnership's recapture is allocated among the partners in proportion to their relative shares of depreciation and amortization in the property limited to the partner's share of total gain.

APPLICATION OF THE BUSINESS INTEREST DEDUCTION LIMITATION TO PARTNERSHIPS (REG. SECTION 1.163(J)-6)

If the deduction under Section 163(j) for business interest expense is subject to limitation, that limitation applies at the partnership or S corporation level. The deduction for business interest expense applies in computing the non-separately stated income of the partnership or S corporation.[58] The regulation notes:

> Once a partnership or an S corporation determines its business interest expense, business interest income, ATI, and floor plan financing interest expense, the partnership or S corporation calculates its Section 163(j) limitation by applying the rules of Section 1.163(j)-2(b) and this section.[59]

Definitions

The following definitions apply for this regulation.

> Section 163(j) items—"The term Section 163(j) items means the partnership or S corporation's business interest expense, business interest income, and items comprising ATI."[60]

[58] Reg. Section1.163(j)-6(a)

[59] Reg. Section1.163(j)-6(a)

[60] Reg. Section1.163(j)-6(b)(1)

Partner basis items—"The term partner basis items means any items of income, gain, loss, or deduction resulting from either an adjustment to the basis of partnership property used in a non-excepted trade or business made pursuant to Section 743(b) or the operation of Section 704(c)(1)(C)(i) with respect to such property. Partner basis items also include Section 743(b) basis adjustments used to increase or decrease a partner's share of partnership gain or loss on the sale of partnership property used in a non-excepted trade or business (as described in Section 1.743-1(j)(3)(i)) and amounts resulting from the operation of Section 704(c)(1)(C)(i) used to decrease a partner's share of partnership gain or increase a partner's share of partnership loss on the sale of such property."[61]

Remedial items—"The term remedial items means any allocation to a partner of remedial items of income, gain, loss, or deduction pursuant to Section 704(c) and Section 1.704-3(d)."[62]

Excess business interest income—"The term excess business interest income means the amount by which a partnership's or S corporation's business interest income exceeds its business interest expense in a taxable year."[63]

Deductible business interest expense—"The term deductible business interest expense means the amount of a partnership's or S corporation's business interest expense that is deductible under Section 163(j) in the current taxable year following the application of the limitation contained in Section 1.163(j)-2(b)."[64]

Section 163(j) excess items—"The term Section 163(j) excess items means the partnership's excess business interest expense, excess taxable income, and excess business interest income."[65]

Non-excepted assets—"The term non-excepted assets means assets from a non-excepted trade or business."[66]

Excepted assets—"The term excepted assets means assets from an excepted trade or business."[67]

Character of Business Interest Expense

If a partnership has deductible business interest expense under IRC Section 163(j), the deduction is not subject to a second test for the limitation at the partner level as it becomes part of nonseparately stated income. But the interest retains its status as business interest for all other purposes under the IRC.[68]

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[61] Reg. Section1.163(j)-6(b)(2)

[62] Reg. Section1.163(j)-6(b)(3)

[63] Reg. Section1.163(j)-6(b)(4)

[64] Reg. Section1.163(j)-6(b)(5)

[65] Reg. Section1.163(j)-6(b)(6)

[66] Reg. Section1.163(j)-6(b)(7)

[67] Reg. Section1.163(j)-6(b)(8)

[68] Reg. Section1.163(j)-6(c)

The regulation specifically points out how the interest retains its status for the passive activity loss rules of Section 469:

> For example, for purposes of Section 469, such business interest expense retains its character as either passive or non-passive in the hands of the partner. Additionally, for purposes of Section 469, deductible business interest expense and excess business interest expense from a partnership remain interest derived from a trade or business in the hands of a partner even if the partner does not materially participate in the partnership's trade or business activity. For additional rules regarding the interaction between Sections 465, 469, and 163(j), see Section 1.163(j)-3.[69]

Adjusted Taxable Income (ATI) of the Partnership

The modification of the calculation of ATI for a partnership is outlined below:

> For purposes of computing a partnership's ATI under Section 1.163(j)-1(b)(1), the tentative taxable income of a partnership is the partnership's taxable income determined under Section 703(a), but computed without regard to the application of the Section 163(j) limitation. (2) Section 734[70]

The interaction of Section 734(b), partner basis items and remedial items is discussed in the regulations:

> A partnership takes into account items resulting from adjustments made to the basis of its property pursuant to Section 734(b) for purposes of calculating its ATI pursuant to Section 1.163(j)-1(b)(1). However, partner basis items and remedial items are not taken into account in determining a partnership's ATI under Section 1.163(j)-1(b)(1). Instead, partner basis items and remedial items are taken into account by the partner in determining the partner's ATI pursuant to Section 1.163(j)-1(b)(1).[71]

Modification of the ATI of the Partner

The ATI of a partner is determined without regard to the partner's distributive share of any item of income, gain, deduction, or loss of the partnership. The ATI is also increased by the partner's share of any excess taxable income of the partnership as determined under Reg. Section 1.163(j)-4(f).[72]

As well, a partner's basis and remedial items are treated as items derived by the partner from the partnership in determining the partner's ATI. If a partner is allocated remedial items, the partners' ATI is increased or decreased by the amount of such items. To the extent the partner is allocated partner basis items, the partner's ATI is increased or decreased by such items.[73]

[69] Reg. Section1.163(j)-6(c)

[70] Reg. Section1.163(j)-6(d)(1)

[71] Reg. Section1.163(j)-6(d)(2)

[72] Reg. Section1.163(j)-6(e)(1)

[73] Reg. Section1.163(j)-6(e)(2)

If a partner disposes of a partnership interest where the partnership owns only non-excepted trade or business assets, the gain or loss on disposition of the interest is included in the partner's ATI.[74]

To avoid double counting of business interest income and floor plan financing interest, for purposes of calculating a partner's Section 163(j) limitation a partner does not include:

- Business interest income from a partnership that is subject to Section 163(j) except to the extent it is allocated excess business interest income from that partnership; and

- The partner's allocable share of the partnership's floor plan financing interest expense because such floor plan financing interest expense has already been taken into account by the partnership in determining its nonseparately stated taxable income or loss for purposes of Section 163(j).[75]

Allocation & Determination of Section 163(j) Excess Items

The allocation and determination of Section 163(j) excess items is made in the same manner as nonseparately stated taxable income and loss of the partnership. Such allocation is considered made in such fashion if, and only if, such allocations and determinations are made in accordance with the eleven-step computation provided in this regulation is used.[76]

Fundamentally, this process is meant to deal with the fact that partnerships can and often do have very complex allocations of different items of partnership income and expense. If each partner computed ATI, business interest income/expense, and the disallowed business interest expense based solely on what is allocated to that partner, the total amount of allowed business interest expense by looking at each's partner's share of items would vary wildly from the amount computed at the partnership level.

Because that partnership level calculation is supposed to control the overall results for the partners in the aggregate, this process seeks to come with a method to allocate the amounts computed for the partnership as a whole to the individual partners.

Because S corporations don't have access to special allocations or non-remedial Section 704(c) allocations, their allocations do not create this same problem—thus the reason why this 11-step process only applies to partnerships.

The regulation describes the process as follows:

> A partnership first determines its Section 163(j) limitation, total amount of deductible business interest expense, and Section 163(j) excess items under paragraph (f)(2)(i) of this Section. The partnership then applies paragraphs (f)(2)(ii) through (xi) of this section, in that order, to determine how those items of the partnership are allocated among its partners. At the conclusion of the eleven-step computation set forth in paragraphs (f)(2)(i) through (xi) of this section, the total amount of deductible business interest expense and Section 163(j) excess items allocated to each partner will equal the partnership's total amount of deductible business interest expense and Section 163(j) excess items.[77]

[74] Reg. Section1.163(j)-6(e)(3)

[75] Reg. Section1.163(j)-6(e)(4)

[76] Reg. Section1.163(j)-6(f)(1)

[77] Reg. Section1.163(j)-6(f)(1)

These rules do not otherwise change allocations under IRC Section 704, as the regulation notes:

> No rule set forth in paragraph (f)(2) of this section prohibits a partnership from making an allocation to a partner of any item of partnership income, gain, loss, or deduction that is otherwise permitted under Section 704 and the regulations under Section 704 of the Code. Accordingly, any calculations in paragraphs (f)(2)(i) through (xi) of this section are solely for the purpose of determining each partner's deductible business interest expense and Section 163(j) excess items and do not otherwise affect any other provision under the Code, such as Section 704(b). Additionally, floor plan financing interest expense is not allocated in accordance with paragraph (f)(2) of this section. Instead, floor plan financing interest expense of a partnership is allocated to its partners under Section 704(b) and is taken into account as a nonseparately stated item of loss for purposes of Section 163(j).[78]

The 11-step process is outlined in the regulations as follows.

Step 1: Partnership-Level Calculation Required by Section 163(j)(4)(A)

The partnership first computes its overall business interest limitation. As the regulations note:

> First, a partnership must determine its Section 163(j) limitation pursuant to Section 1.163(j)-2(b). This calculation determines a partnership's total amounts of excess business interest income, excess taxable income, excess business interest expense (that is, the partnership's Section 163(j) excess items), and deductible business interest expense under Section 163(j) for a taxable year.[79]

Step 2: Determination of Each Partner's Relevant Section 163(j) Items

The partnership next computes a determination of each partner's relevant Section 163(j) items that are allocated to the partner under IRC Sections 704(b) and (c) (other than remedial items). The regulation describes this process as follows:

> Second, a partnership must determine each partner's allocable share of each Section 163(j) item under Section 704(b) and the regulations under Section 704 of the Code, including any allocations under Section 704(c), other than remedial items. Only Section 163(j) items that were actually taken into account in the partnership's Section 163(j) calculation under paragraph (f)(2)(i) of this section are taken into account for purposes of this paragraph (f)(2)(ii). Partner basis items, allocations of investment income and expense, remedial items, and amounts determined for the partner under Section 1.163-8T are not taken into account for purposes of this paragraph (f)(2)(ii). For purposes of paragraphs (f)(2)(ii) through (xi) of this section, the term allocable ATI means a partner's distributive share of the partnership's ATI (that is, a partner's distributive share of gross income and gain items comprising ATI less such partner's distributive share of gross loss and deduction items comprising ATI), the term allocable business interest income means a partner's distributive share of the partnership's business interest income, and the term allocable business interest expense means a partner's distributive share of the partnership's business interest expense that is not floor plan financing interest

[78] Reg. Section1.163(j)-6(f)(1)(i)

[79] Reg. Section1.163(j)-6(f)(2)(i)

> expense. If the partnership determines that each partner has a pro rata share of allocable ATI, allocable business interest income, and allocable business interest expense, then the partnership may bypass paragraphs (f)(2)(iii) through (xi) of this section and allocate its Section 163(j) excess items in the same proportion. See Example 1 through Example 16 in paragraphs (o)(1) through (16), respectively. This pro-rata exception does not result in allocations of Section 163(j) excess items that vary from the array of allocations of Section 163(j) excess items that would have resulted had paragraphs (f)(2)(iii) through (xi) been applied.[80]

Step 3: Partner-Level Comparison of Business Interest Income & Business Interest Expense

Third, the regulation requires a partner-level comparison of business interest income and business interest expense. As the regulation notes:

> Third, a partnership must compare each partner's allocable business interest income to such partner's allocable business interest expense. Paragraphs (f)(2)(iii) through (v) of this section determine how a partnership must allocate its excess business interest income among its partners, as well as the amount of each partner's allocable business interest expense that is not deductible business interest expense after taking the partnership's business interest income into account. To the extent a partner's allocable business interest income exceeds its allocable business interest expense, the partner has an allocable business interest income excess. The aggregate of all the partners' allocable business interest income excess amounts is the total allocable business interest income excess. To the extent a partner's allocable business interest expense exceeds its allocable business interest income, the partner has an allocable business interest income deficit. The aggregate of all the partners' allocable business interest income deficit amounts is the total allocable business interest income deficit. These amounts are required to perform calculations in paragraphs (f)(2)(iv) and (v) of this section, which appropriately reallocate allocable business interest income excess to partners with allocable business interest income deficits in order to reconcile the partner-level calculation under paragraph (f)(2)(iii) of this section with the partnership-level result under paragraph (f)(2)(i) of this section.[81]

Step 4: Matching Partnership & Aggregate Partner Excess Business Interest Income

The partnership's fourth step is to match partnership and aggregate partner excess business interest income. The regulation provides:

> Fourth, a partnership must determine each partner's final allocable business interest income excess. A partner's final allocable business interest income excess is determined by reducing, but not below zero, such partner's allocable business interest income excess (if any) by the partner's step four adjustment amount. A partner's step four adjustment amount is the product of the total allocable business interest income deficit and the ratio of such partner's allocable business interest income excess to the total allocable business interest income excess. The rules of

[80] Reg. Section1.163(j)-6(f)(2)(ii)

[81] Reg. Section1.163(j)-6(f)(2)(iii)

> this paragraph (f)(2)(iv) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess business interest income equals the total amount of the partnership's excess business interest income as determined in paragraph (f)(2)(i) of this section.[82]

Without this step, if there exists some partners with allocable business income excess, the total allocable business income deficit would be greater than the actual net business interest income deficit of the partnership. This calculation reduces the allocable business interest income excess of the partners to account for the use of that excess to reduce what otherwise would be business interest income deficit.

Step 5: Remaining Business Interest Expense Determination

Step five involves determining each partner's remaining business interest expense. The regulation provides:

> Fifth, a partnership must determine each partner's remaining business interest expense. A partner's remaining business interest expense is determined by reducing, but not below zero, such partner's allocable business interest income deficit (if any) by such partner's step five adjustment amount. A partner's step five adjustment amount is the product of the total allocable business interest income excess and the ratio of such partner's allocable business interest income deficit to the total allocable business interest income deficit. Generally, a partner's remaining business interest expense is a partner's allocable business interest income deficit adjusted to reflect a reallocation of allocable business interest income excess from other partners. Determining a partner's remaining business interest expense is necessary to perform an ATI calculation that begins in paragraph (f)(2)(vii) of this section.[83]

Step 6: Determination of Final Allocable ATI

The sixth step involves determination each partner's final allocable ATI. This step first begins with partners that have positive ATI:

> To the extent a partner's income and gain items comprising its allocable ATI exceed its deduction and loss items comprising its allocable ATI, the partner has positive allocable ATI. The aggregate of all the partners' positive allocable ATI amounts is the total positive allocable ATI.[84]

Step six continues by looking at partners with negative allocable ATI:

> To the extent a partner's deduction and loss items comprising its allocable ATI exceed its income and gain items comprising its allocable ATI, the partner has negative allocable ATI. The aggregate of all the partners' negative allocable ATI amounts is the total negative allocable ATI.[85]

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[82] Reg. Section1.163(j)-6(f)(2)(iv)

[83] Reg. Section1.163(j)-6(f)(2)(v)

[84] Reg. Section1.163(j)-6(f)(2)(vi)(A)

[85] Reg. Section1.163(j)-6(f)(2)(vi)(B)

Step six concludes with the computation of the final allocable ATI:

> Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Any partner with a positive allocable ATI of $0 has a final allocable ATI of $0. The final allocable ATI of any partner with a positive allocable ATI greater than $0 is such partner's positive allocable ATI reduced, but not below zero, by the partner's step six adjustment amount. A partner's step six adjustment amount is the product of the total negative allocable ATI and the ratio of such partner's positive allocable ATI to the total positive allocable ATI. The total of the partners' final allocable ATI amounts must equal the partnership's ATI amount used to compute its Section 163(j) limitation pursuant to Section 1.163(j)-2(b).[86]

This is yet another adjustment that seeks to reduce the total of the partner's item (in this case, positive ATI) to the overall ATI of the partnership by burdening each partner with a positive ATI with his/her allocable share of the overall negative ATI.

Step 7: Partner-Level Comparison of 30 Percent of Adjusted Taxable Income & Remaining Business Interest Expense

Step seven involves a partner-level comparison of 30 percent of adjusted taxable income and remaining business interest expense, creating a determination of an ATI excess or deficit for each partner that is used in steps 9 and 10. As the regulation notes:

> Seventh, a partnership must compare each partner's ATI capacity to such partner's remaining business interest expense as determined under paragraph (f)(2)(v) of this section. A partner's ATI capacity is the amount that is 30 percent of such partner's final allocable ATI as determined under paragraph (f)(2)(vi) of this section. A partner's final allocable ATI is grossed down to 30 percent prior to being compared to its remaining business interest expense in this calculation to parallel the partnership's adjustment to its ATI under Section 163(j)(1)(B). To the extent a partner's ATI capacity exceeds its remaining business interest expense, the partner has an ATI capacity excess. The aggregate of all the partners' ATI capacity excess amounts is the total ATI capacity excess. To the extent a partner's remaining business interest expense exceeds its ATI capacity, the partner has an ATI capacity deficit. The aggregate of all the partners' ATI capacity deficit amounts is the total ATI capacity deficit. These amounts (which may be subject to adjustment under paragraph (f)(2)(viii) of this section) are required to perform calculations in paragraphs (f)(2)(ix) and (x) of this section, which appropriately reallocate ATI capacity excess to partners with ATI capacity deficits in order to reconcile the partner-level calculation under paragraph (f)(2)(vii) of this section with the partnership-level result under paragraph (f)(2)(i) of this section.[87]

Step 8: Partner Priority Right to ATI Capacity Excess Determination

This step is undertaken to account for adjustments made in step 4 to a partner's allocable ATI to ensure that the partners who had a negative allocable ATI do not inappropriately benefit under the rules of steps 9 through 11.[88]

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[86] Reg. Section1.163(j)-6(f)(2)(vi)(C)

[87] Reg. Section1.163(j)-6(f)(2)(vii)

[88] Reg. Section1.163(j)-6(f)(viii)(A)

The eighth step involves the adjustments referenced in the seventh step, if they prove to be necessary. The three conditions described in the regulation cited below must be met for these adjustments to be made:

> The partnership must perform the calculations and make the necessary adjustments described under paragraphs (f)(2)(viii)(B) and (C) or paragraph (f)(2)(viii)(D) of this section if, and only if, there is--
>
> 1. An excess business interest expense amount greater than $0 under Step 1;
>
> 2. A total negative allocable ATI amount greater than $0 under Step 6; and
>
> 3. A total ATI capacity excess amount greater than $0 under Step 7.[89]

If those conditions are satisfied, the partnership must calculate each partner's priority amount. As the regulation provides:

> A partnership must determine each partner's priority amount and usable priority amount. A partner's priority amount is 30 percent of the amount by which a partner's positive allocable ATI under paragraph (f)(2)(vi)(A) of this section exceeds such partner's final allocable ATI under paragraph (f)(2)(vi)(C) of this section. However, only partners with an ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. The aggregate of all the partners' priority amounts is the total priority amount. A partner's usable priority amount is the lesser of such partner's priority amount or such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section. The aggregate of all the partners' usable priority amounts is the total usable priority amount. If the total ATI capacity excess amount, as determined under paragraph (f)(2)(vii) of this section, is greater than or equal to the total usable priority amount, then the partnership must perform the adjustments described in paragraph (f)(2)(viii)(C) of this section. If the total usable priority amount is greater than the total ATI capacity excess amount, as determined under paragraph (f)(2)(vii) of this section, then the partnership must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.[90]

The regulation goes on to provide the following definitions to be used for the next calculation when the total ATI capacity excess amount is greater than or equal to the total usable priority amount:

> For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATI capacity excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, the following terms have the following meanings for each partner:
>
> 1. Each partner's ATI capacity deficit is such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, reduced by such partner's usable priority amount.
>
> 2. The total ATI capacity deficit is the total ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, reduced by the total usable priority amount.

[89] Reg. Section1.163(j)-6(f)(viii)(A)

[90] Reg. Section1.163(j)-6(f)(viii)(B)

3. The total ATI capacity excess is the total ATI capacity excess as determined under paragraph (f)(2)(vii) of this section, reduced by the total usable priority amount. [91]

However, if total usable priority amount is greater than the total ATI capacity excess amount, the following calculations must be performed:

> Any partner with a priority amount greater than $0 is a priority partner. Any partner that is not a priority partner is a non-priority partner. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATI capacity excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATI capacity deficit amount is such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section. For purposes of paragraph (f)(2)(x) of this section the following terms have the following meanings for priority partners.
>
> 1. Each priority partner must determine its step eight excess share. A partner's step eight excess share is the product of the total ATI capacity excess as determined under paragraph (f)(2)(vii) of this section and the ratio of the partner's priority amount to the total priority amount.
>
> 2. To the extent a priority partner's step eight excess share exceeds its ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, such excess amount is the priority partner's ATI capacity excess for purposes of paragraph (f)(2)(x) of this section. The total ATI capacity excess is the aggregate of the priority partners' ATI capacity excess amounts as determined under this paragraph (f)(2)(viii)(D)(2
>
> 3. To the extent a priority partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section exceeds its step eight excess share, such excess amount is the priority partner's ATI capacity deficit for purposes of paragraph (f)(2)(x) of this section. The total ATI capacity deficit is the aggregate of the priority partners' ATI capacity deficit amounts as determined under this paragraph (f)(2)(viii)(D)(3). [92]

Step 9: Matching Partnership & Aggregate Partner Excess Taxable Income

Step nine involves matching partnership and aggregate partner excess taxable income. As the regulation continues:

> Ninth, a partnership must determine each partner's final ATI capacity excess. A partner's final ATI capacity excess amount is determined by reducing, but not below zero, such partner's ATI capacity excess (if any) by the partner's step nine adjustment amount. A partner's step nine adjustment amount is the product of the total ATI capacity deficit and the ratio of such partner's ATI capacity excess to the total ATI capacity excess. The rules of this paragraph (f)(2)(ix) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess taxable income equals the total amount of the

[91] Reg. Section1.163(j)-6(f)(viii)(C)

[92] Reg. Section1.163(j)-6(f)(viii)(D)

> partnership's excess taxable income as determined in paragraph (f)(2)(i) of this section.93

Step 10: Matching Partnership & Aggregate Partner Excess Business Interest Expense

The 10th step deals with matching partnership and aggregate partner excess business interest expense. The regulation provides:

> Tenth, a partnership must determine each partner's final ATI capacity deficit. A partner's final ATI capacity deficit amount is determined by reducing, but not below zero, such partner's ATI capacity deficit (if any) by the partner's step ten adjustment amount. A partner's step ten adjustment amount is the product of the total ATI capacity excess and the ratio of such partner's ATI capacity deficit to the total ATI capacity deficit. Generally, a partner's final ATI capacity deficit is a partner's ATI capacity deficit adjusted to reflect a reallocation of ATI capacity excess from other partners. The rules of this paragraph (f)(2)(x) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess business interest expense equals the total amount of the partnership's excess business interest expense as determined in paragraph (f)(2)(i) of this section. [94]

Step 11: Final Section 163(j) Excess Item & Deductible Business Interest Expense Allocation

In the 11th step, the partnership allocates excess Section 163(j) excess items and deductible business interest expense. The regulation provides:

> Eleventh, a partnership must allocate Section 163(j) excess items and deductible business interest expense to its partners. Excess business interest income calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar by the partnership to its partners with final allocable business interest income excess amounts. Excess business interest expense calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar to partners with final ATI capacity deficit amounts. After grossing up each partner's final ATI capacity excess amount by ten-thirds, excess taxable income calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar to partners with final ATI capacity excess amounts. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. See Example 17 through Example 21 in paragraphs (o)(17) through (21) of this section, respectively. [95]

[93] Reg. Section1.163(j)-6(f)(ix)

[94] Reg. Section1.163(j)-6(f)(x)

[95] Reg. Section1.163(j)-6(f)(xi)

Carryovers

Business interest expense not allowed as a deduction to the partnership for the taxable year is not treated as business interest expense of the partnership in the following year. Rather, the disallowed amount is treated as excess business interest expense which is allocated to each partner.[96]

Treatment of Excess Business Interest Expense

When a partner is allocated excess business interest expense, it is treated as business interest expense pair or incurred by the partner in the next succeeding tax year when the partner is allocated excess taxable income or excess business interest income from the same partnership. The amount treated as paid or incurred is limited to the extent of such excess taxable income or excess business interest income.[97]

The business interest expense continues to be carried forward unless the partnership later becomes not subject to the interest limitation rules of IRC Section 163(j), at which point the rules found at Reg. Section 1.163-6(m)(3) will generally cause the interest to be treated as paid in that later year and, absent another limitation, be deductible at that time.[98]

Ordering Rule

The regulation provides the following ordering rule for excess taxable income and excess business interest:

> In the event a partner has excess business interest expense from a prior taxable year and is allocated excess taxable income or excess business interest income from the same partnership in a succeeding taxable year, the partner must treat, for purposes of Section 163(j), the excess business interest expense as business interest expense paid or accrued by the partner in an amount equal to the partner's share of the partnership's excess taxable income or excess business interest income in such succeeding taxable year. [99]

Impact on Basis of Partnership Interest

The regulations make clear that the business interest deduction is subject to the loss limitation due to basis for a partner found at IRC Section 704(d).100 Under those rules, when losses are limited in a year, the losses allocated the partner are apportioned among the losses based on the character of the losses by Reg. Section 1.704-1(d)(2), and to allocate proportionately among the various classes of losses that are involved.

For purposes of the general basis loss disallowance rule, any deductible business interest expense and any excess interest expense (whether allocated in the current year or which was suspended due to basis in a prior taxable year) shall comprise the same Section 704(d) loss class. Once the partner has determined the basis related limitation on losses in this class, any deductible business interest expense

[96] Reg. Section1.163(j)-6(g)(1)

[97] Reg. Section1.163(j)-6(g)(2)

[98] Reg. Section1.163(j)-6(g)(2)(ii)

[99] Reg. Section1.163(j)-6(g)(3)

[100] Reg. Section1.163(j)-6(h)(1)

is taken into account before any excess business interest expense or negative Section 163(j) expense. Negative Section 163(j) expense is defined as any excess business interest expense that was suspended due to basis in a prior year under IRC Section 704(d).[101]

Excess Business Interest Expense Basis Adjustments

The adjusted basis of a partner's interest is reduced, but not below zero, by the amount of excess business interest expense allocated to the partner.[102] Negative Section 163(j) expense (that is, excess business interest expense allocated in prior years but suspended under the basis limitation rules), is not treated as excess business interest expense until the negative Section 163(j) expense is no longer suspended due to the basis rules of Section 704(d).[103]

The regulation explains the impact of this as follows:

> Therefore, negative Section 163(j) expense does not affect, and is not affected by, any allocation of excess taxable income to the partner. Accordingly, any excess taxable income allocated to a partner from a partnership while the partner still has negative Section 163(j) expense will be included in the partner's ATI. However, once the negative Section 163(j) expense is no longer suspended under Section 704(d), it becomes excess business interest expense, which is subject to the general rules in paragraph (g) of this section.[104]

Basis Adjustment upon Disposition of Partnership Interest

The regulations rules for dealing with dispositions of a portion or all of a partner's interest.

The general rule provides as follows:

> If a partner (transferor) disposes of an interest in a partnership, the adjusted basis of the partnership interest being disposed of (transferred interest) is increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under paragraph (h)(2) of this section over the portion of any excess business interest expense allocated to the transferor under paragraph (f)(2) of this section which has previously been treated under paragraph (g) of this section as business interest expense paid or accrued by the transferor, multiplied by the ratio of the fair market value of the transferred interest to the total fair market value of the transferor's partnership interest immediately prior to the disposition. Therefore, the adjusted basis of the transferred interest is not increased immediately before the disposition by any allocation of excess business interest expense from the partnership that did not reduce the transferor's adjusted basis in its partnership interest pursuant to paragraph (h) of this section prior to the disposition, or by any excess business interest expense that was treated under paragraph (g) of this section as business interest expense paid or accrued by the transferor prior to the disposition.[105]

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[101] Reg. Section1.163(j)-6(h)(1)

[102] Reg. Section1.163(j)-6(h)(2)

[103] Reg. Section1.163(j)-6(h)(2)

[104] Reg. Section1.163(j)-6(h)(2)

[105] Reg. Section1.163(j)-6(h)(3)

The regulations provide that, for purposes of these rules, the following transactions are treated as dispositions:

> For purposes of this paragraph, a disposition includes a distribution of money or other property by the partnership to a partner in complete liquidation of its interest in the partnership. Further, solely for purposes of this section, each partner is considered to have disposed of its partnership interest if the partnership terminates under Section 708(b)(1).[106]

The regulations provide that a disposition does *not* permit the partner to treat either excess business interest or negative Section 163(j) expense as an interest deduction for the year of sale:

> If the transferor disposes of all of its partnership interest, no deduction under Section 163(j) is allowed to the transferor or transferee under chapter 1 of subtitle A of the Code for any excess business interest expense or negative Section 163(j) expense. If the transferor disposes of a portion of its partnership interest, no deduction under Section 163(j) is allowed to the transferor or transferee under chapter 1 of subtitle A of the Code for the amount of excess business interest expense proportionate to the transferred interest.[107]

When the transferor retains some portion of the partnership interest, the regulations provide for the following treatments for excess business interest expense and negative Section 163(j) expense:

> The amount of excess business interest expense proportionate to the partnership interest retained by the transferor shall remain as excess business interest expense of the transferor until such time as such excess business interest expense is treated as business interest expense paid or accrued by the transferor pursuant to paragraph (g) of this section. Further, if the transferor disposes of a portion of its partnership interest, any negative Section 163(j) expense shall remain negative Section 163(j) expense of the transferor partner until such negative Section 163(j) expense is no longer suspended under Section 704(d).[108]

Impact on Investment Income/Expense Under Reg. Section 1.163-8T

Any partnership item that is either investment income or expense under Reg. Section 1.163-8T (related to the investment interest limitation on individuals, trusts and estates) is to be allocated to each partner in accordance with the existing regulations for allocations under IRC Section 704(b). The effect of the allocation will be determined at the partner level for purposes of any interest deduction under IRC Section 163.[109]

ALLOCATIONS FOR YEAR IN WHICH PARTNER'S INTEREST CHANGES

The IRS in 2015 issued final regulations (TD 9728) under IRC Section 706 dealing with the issue of when partners hold varying interests in a partnership during the year. Also, the IRS issued new

[106] Reg. Section1.163(j)-6(h)(3)
[107] Reg. Section1.163(j)-6(h)(3)
[108] Reg. Section1.163(j)-6(h)(3)
[109] Reg. Section1.163(j)-6(k)

proposed regulations, concurrent with these final regulations, which deal with the interplay between the tiered partnership rules and cash basis rules when there is a change in the partners' interests (REG- 109370-10).

The final regulations are issued to cover the general rule, found at IRC Section 706(d)(1), that provides:

> if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

There are two exceptions to these rules, found at IRC Sections 706(d)(2) and (3) that deal with certain cash basis items in this situation and items that exist in a lower-tier partnership. The proposed regulations deal with these issues, as the IRS found that it was not appropriate to attempt to add guidance on those issues to these final regulations in response to comments.

These final regulations, based on proposed regulations issued in 2009, provide for rules for determining a partner's distributive share of partnership items in a year where there is a change in a partner's interest in the partnership due to any of the following:

- Disposition of a partner's entire interest in the partnership
- Disposition of less than a partner's entire interest in the partnership
- Reduction of a partner's interest in a partnership due to the entry of a new partner (or partners) (See Reg. Sections 1.706-1(c)(2) and (3))

There are two exceptions to the applications of these rules.

- **Contemporaneous partners**—The rule does not apply to modifications of distributive shares among partners who were members of the partnership during either (1) the entire year or (2) the period in which the revised allocation applies, so long as:
  - any variation in a partner's interest is not attributable to a contribution of money or property by a partner to the partnership or a distribution of money or property by the partnership to a partner; and
  - the allocations resulting from the modification satisfy the provisions of Section 704(b) and the related regulations for respecting allocations.
- **Service partnership exception**—So long as capital is not a material income-producing factor, the partnership can choose to allocate items using any reasonable method that satisfies the provisions of Section 704(b) and the related regulations regardless of a change in interest. This represents an expansion of this rule compared to the proposed regulations, which limited the partnerships qualifying for this rule to only those in specified personal service industries.

For the year in which a change in interest required to be computed under these regulations takes place, the partnership can account for the varying interest using either the interim closing method or the proration method. The partnership must use the interim closing method unless there is an

agreement by the partners to use the proration method. However, subject to any restrictions the IRS may later announce, the partnership does not have to use the same method to deal with each separate variation that takes place in the tax year (Reg. Section 1.7044(a)(3)(iii)).

Except for allocations dealing with extraordinary items, the partnership may adopt a separate closing convention period and perform interim closings of the books on a mid-month or monthly basis as opposed to a per-day basis. If there is no agreement of the partners, then the partnership must use the calendar convention (Reg. Section 1.7064(c)).

If the monthly convention is used, any change in interest occurring on the 1st through the 15th day of the month will be treated as occurring as of the end of the preceding month. Those occurring on the 16th day or later will be treated as having occurred at the end of the month in which the variation occurred (Reg. Section 1.706 4(c)(1)(iii)).

If the mid-month convention is used, any change in interest occurring on the 1st through the 15th day of the month will be treated as occurring as of the end of the preceding month. Those occurring on the 16th day or later will be treated as having occurred on the 15th day of the month in which the variation occurred (Reg. Section 1.706 4(c)(1)(ii)).

Generally, the same proration method must be used for all variations during the year in which the partnership uses the interim closing method.

However, regardless of the convention used, all variations within the tax year will be deemed to occur no earlier than the first day of the tax year and no later than the last day of the tax year. If the monthly convention is used, any change in interest occurring on the 1st through the 15th day of the month will be treated as occurring as of the end of the preceding month. Those occurring on the 16th day or later will be treated as having occurred at the end of the month in which the variation occurred (Reg. Section 1.706 4(c)(2)(i)).

Also, if a person both becomes a partner as the result of one variation and ceases to be a partner as a result of another variation and, under the selected convention, both changes are deemed to occur on the same day, then the variations for that partner's interest will be treated as occurring on the day the variations actually occurred and not according to the convention (Reg. Section 1.7064(c)(2)(ii)).

For "extraordinary items," a per-day allocation is required—that is, no convention may be used. The extraordinary items, listed at Reg. Section 1.704-4(e)(2), are:

- any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset as defined in Section 1221 (determined without the application of any other rules of law)
- any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business as defined in Section 1231(b) (determined without the application of any holding period requirement)
- any item from the disposition or abandonment of an asset described in Sections 1221(a)(1), (a)(3), (a)(4), or (a)(5) if substantially all of the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions)
- any item from assets disposed of in an applicable asset acquisition under Section 1060(c)

- any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs
- any item from the discharge or retirement of indebtedness (except discharges subject to the special allocation rules of Sections 108(e)(8) and 108(i)
- any item from the settlement of a tort or similar third-party liability or payment of a judgment
- any credit, to the extent it arises from activities or items that are not ratably allocated (e.g., the rehabilitation credit under Section 47, which is based on placement in service)
- for all partnerships, any additional item if the partners agree to consistently treat the item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (e.g., the limitation for Section 179 expenses)
- any item that, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included
- any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin

Generally, extraordinary items must be accounted for using an interim closing and cannot be accounted for using a proration method. The regulation actually goes so far to look at the time of day that an individual became or ceased to be a partner for purposes of determining the allocation of an extraordinary item (Reg. Section 1.706 4(e)(1)).

However, publicly traded partnerships (PTPs) are allowed to use their conventions to determine who is treated as a partner at the time of occurrence of the extraordinary item (Reg. Section 1.706 4(e)(1)).

The regulations require dividing up the partnership year into segments based on the dates of changes in interest. The regulation outlines the steps the partnership is to take as follows.

1. First, determine whether either of the exceptions described earlier (regarding certain changes among contemporaneous partners and partnerships for which capital is not a material income-producing factor) applies.
2. Second, determine which of its items are subject to allocation under the special rules for extraordinary items and allocate those items accordingly.
3. Third, determine with respect to each variation whether it will apply the interim closing method or the proration method. Absent an agreement of the partners to use the proration method, the partnership shall use the interim closing method. The partnership may use different methods (interim closing or proration) for different variations within each partnership taxable year; however, the Commissioner may place restrictions on the ability of partnerships to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.
4. Fourth, determine when each variation is deemed to have occurred under the partnership's selected convention.

5. Fifth, determine whether there is an agreement of the partners to perform regular monthly or semimonthly interim closings. If so, then the partnership will perform an interim closing of its books at the end of each month (in the case of an agreement to perform monthly closings) or at the end and middle of each month (in the case of an agreement to perform semimonthly closings), regardless of whether any variation occurs. Absent an agreement of the partners to perform regular monthly or semimonthly interim closings, the only interim closings during the partnership's taxable year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method.

6. Sixth, determine the partnership's segments, which are specific periods of the partnership's taxable year created by interim closings of the partnership's books. The first segment shall commence with the beginning of the taxable year of the partnership and shall end at the time of the first interim closing. Any additional segment shall commence immediately after the closing of the prior segment and shall end at the time of the next interim closing. However, the last segment of the partnership's taxable year shall end no later than the close of the last day of the partnership's taxable year. If there are no interim closings, the partnership has one segment, which corresponds to its entire taxable year.

7. Seventh, apportion the partnership's items for the year among its segments. The partnership shall determine the items of income, gain, loss, deduction, and credit of the partnership for each segment. In general, a partnership shall treat each segment as though the segment were a separate distributive share period. For example, a partnership may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. For purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will be applied based upon the partnership's satisfaction of the limitation or requirement as of the end of the partnership's taxable year. For example, the expenses related to the election to expense a Section 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method.

8. Eighth, determine the partnership's proration periods, which are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method. The first proration period in each segment begins at the beginning of the segment and ends at the time of the first variation within the segment for which the partnership selects the proration method. The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnership selects the proration method. However, each proration period shall end no later than the close of the segment.

9. Ninth, prorate the items of income, gain, loss, deduction, and credit in each segment among the proration periods within the segment.

10. Tenth, determine the partners' distributive shares of partnership items under Section 702(a) by taking into account the partners' interests in such items during each segment and proration period.

Note that many provisions reference things that can only be done if there is an "agreement of the partners" with regard to the item. The regulations provide for specific requirements for such an agreement and the maintenance of certain records.

Specifically, Reg. Section 1.7064(f) provides:

> the term agreement of the partners means either an agreement of all the partners to select the method, convention, or extraordinary item in a dated, written statement maintained with the partnership's books and records, including, for example, a selection that is included in the partnership agreement, or a selection of the method, convention, or extraordinary item made by a person authorized to make that selection, including under a grant of general authority provided for by either state law or in the partnership agreement, if that person's selection is in a dated, written statement maintained with the partnership's books and records. In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.

THE REGULATIONS ARE NOT ALWAYS DETERMINATIVE

The regulations under Section 704 contain a provision that provides that determinations of distributions that comply with the detailed rules of the regulations under Section 704(b) may still not be conclusive as to the tax treatment of a partner. For example, allocations that pass the tests of Section 704(b) may be invalid under another code section or the general assignment of income principles or be inconsistent with the intent of Section 704(b) and thus invalid under the anti-abuse rule of Section 701.

Unit 6

Transactions Between Partners & the Partnership

LEARNING OBJECTIVES

- **Apply** both the entity and aggregate concepts of taxation to partner and partnership transactions.
- **Determine** the tax effects on the partner and the partnership from such transactions.
- **Identify** and **plan** guaranteed payments to partners.
- **Apply** general related party limitation provisions to partnership transactions.
- **Apply** specific related party limitations of Subchapter K.

INTRODUCTION

Several different types of transactions may occur between a partnership and its partners. When a partner engages in a transaction with a partnership of which she is a member, the tax treatment of the transaction depends on whether the entity or aggregate concept of partnership taxation applies.

Entity & Aggregate Alternatives

Under the entity concept, the partnership is treated as a separate and distinct entity, and the transaction should be recognized for tax purposes. Under the aggregate concept, the partnership is treated as an aggregation of individual partners, and the transaction should be ignored for tax purposes, at least to the extent that partners are dealing with themselves as members of the partnership. Consider the following example:

EXAMPLE

Entity vs. Aggregate Theory

Assume that Mark (a 50% partner) sells property to the Landgrab Partnership for the property's fair market value (FMV) of $1,000. The property has a basis of $400 in Mark's hands.

Under the entity concept, the transaction would be recognized for tax purposes and Mark would recognize $600 gain. Under the aggregate concept, the transaction would be treated as a sale of half of Mark's property to his partner followed by each of them contributing their interest in the property to the partnership. Mark would recognize $300 gain. The other half of the property would not be affected as Mark cannot sell to himself.

IRC Section 707(a)(1) generally applies the entity concept to transactions between a partnership and its partners. IRC Section 707(a)(1) provides:

> [i]f a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this Section, be considered as occurring between the partnership and one who is not a partner.

In most cases, when a partner acts in a capacity other than as a partner and engages in a transaction with his partnership, the transaction is treated as one between the partnership and one who is a stranger.

Limitations on Application of the Entity Concept

Since the implementation of the 1954 code, the aggregate concept, not the entity concept adopted by IRC Section 707(a)(1), is applied to transactions between a partner and a partnership, where that concept is more appropriate to the transaction.

IRC Section 707(b) limits the entity rule of Section 707(a)(1). Under IRC Section 707(b), realized losses are disallowed on sales between partners and controlled partnerships or between controlled partnerships. Additionally, gains realized on certain sales between partners and controlled partnerships or between controlled partnerships are treated as ordinary income.

This rule effectively prohibits the sale of real property (as well as other capital assets) between related partnerships where the purchasing partnership will develop the property or where the property will be inventory in the hands of the purchasing partnership.

IRC Section 267 further limits the entity concept with respect to partner and partnership transactions. IRC Section 267 prevents an accrual-method payor from deducting amounts owed to related cash-method payees until the amount is paid. For purposes of this rule, a partnership and each of its partners (without regard to ownership percentage) are related persons for purposes of the matching rule of IRC Section 267.

IRC Section 707(c) completes the statutory scheme with respect to partner and partnership transactions. IRC Section 707(c) addresses the tax consequences of guaranteed payments made by a partnership to a partner for services performed in his capacity as a partner and for interest payments made with respect to his capital account.

Basic Analysis of Partner & Partnership Transactions

The starting point in determining the tax treatment of a partner and partnership transaction is deciding whether or not a partner is acting in his capacity as a partner with respect to a particular transaction. This is a question that depends on the relevant facts and circumstances. Reg. Section 1.707-1(a) provides that the substance of a transaction, rather than its form, will be the governing factor.

The partner and partnership's characterization of the transaction is significant in the determination, however. IRC Section 707(a)(2) provides that allocations and distributions to partners should be recharacterized as payments to non-partners for services or property if that is what they are in substance. IRC Section 707(a)(2) is discussed later in this chapter.

In summary, see the following list.

- If a partner is not acting in her capacity as a partner, IRC Section 707(a)(1) should apply to the transaction, except to the extent limited by IRC Section 707(b) or IRC Section 267. Under IRC Section 707(a)(1), the transaction is treated as if it occurred between unrelated parties.
- If a partner is acting as a partner and the payment to the partner is determined without regard to the partnership income, the transaction is governed by IRC Section 707(c).
- If a partner is acting in her capacity as a partner and the payment to the partner is determined with regard to partnership income, neither IRC Section 707(a)(1) nor IRC Section 707(c) applies. In this case, the payment is treated as a distributive share of partnership income.

A detailed analysis of partner and partnership transactions is provided in the following sections of this chapter:

- Partners Acting in Non-partner Capacities: IRC Section 707(a)(1) Transactions
- Disguised Payments to Partners for Property or Services: IRC Section 707(a)(2)
- Limitations on Sales Between Partnerships and Controlling Partners: IRC Section 707(b)
- Matching of Income and Deductions in a Transaction Between Related Parties: IRC Section 267
- Guaranteed Payments: IRC Section 707(c)

PARTNERS ACTING IN NON-PARTNER CAPACITIES: IRC SECTION 707(A)(1) TRANSACTIONS

Under IRC Section 707(a)(1), a partnership is a separate entity from the partners whenever a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership. Subject to the limitations of IRC Section 707(b) and IRC Section 267 (discussed later in this module), transactions to which IRC Section 707(a) apply are treated as occurring between the partnership and an unrelated party.

Transactions governed by IRC Section 707(a)(1) include:

- loans between the partnership and a partner,
- sales of property between the partnership and a partner,
- services performed by the partner for the partnership or by the partnership for the partner, and
- leases of property between partners and partnerships.

A transaction is governed by IRC Section 707(a) only when the partner is not acting in his capacity as a partner.

Loans Between Partner & Partnership

If a partner is not acting in his capacity as partner, Reg. Section 1.707-1(a) states that, under IRC Section 707(a), loans of money or property between partners and partnerships are treated as transactions between unrelated parties.

The substance rather than the form of a transaction is controlling (Reg. Section 1.707-1(a)). Courts have examined these transactions by applying tests similar to the debt-equity test used in corporate taxation. If a loan by a partner to his partnership more closely resembles an investment, it may be recharacterized as a capital contribution. Similarly, a purported loan from a partnership to a partner may be recharacterized as a partnership distribution if more appropriate to reflect the substance of a transaction.

Clearly documentation of the transaction plays a crucial role in determining whether a transaction is a loan or a capital contribution or distribution. While the IRS won't automatically concede a transaction is a loan with complete documentation, since such documentation isn't controlling, having a well-documented transaction clearly increases the likelihood that the transaction will be respected.

If the transaction is intended to be a loan, there should be:

- a note;
- a reasonable interest rate (not less than the imputed interest rate in effect at the date of the note);
- repayment terms that are reasonable;
- collateral assignments, if appropriate;
- approval of the partners, if required; and
- a provision in the partnership agreement permitting such loans.

If a transaction is correctly characterized as a loan by a partner acting as other than a partner, IRC Section 707(a) governs the transaction. Interest paid to the partner by the partnership is deductible by the partnership and includable as ordinary income by the partner. The interest is treated, under IRC Sections 61(a) and 163, like interest on third-party loans. However, under IRC Section 267(e), if an accrual basis partnership is paying interest to a cash-basis partner, the partnership can't deduct the interest until the interest is paid and included in the cash-basis partner's income. This related party

rule applies as well to any cash basis taxpayer who indirectly holds an interest in the partnership or any person related to a partner.

If, on the other hand, a partner loan is characterized as a capital contribution, interest paid to the partner would be treated as IRC Section 707(c) guaranteed payments. Guaranteed payments are discussed later in this module, including the key differences in the timing of recognition of the parties versus the payments governed by IRC Section 267.

Sales of Property

Once a transaction between a partnership and partner is properly classified as a sale, it is treated as occurring between the partnership and one who is not a partner. Subject to the limitations of IRC Section 707(b), the general tax rules with respect to realization, recognition, and characterization of gain or loss apply. (The limitations of IRC Section 707(b) are discussed later in this module.)

The substance of a transaction is controlling in determining if a transaction is properly classified as a sale. If a sale of property by a partner to a partnership is in substance a contribution of the property to the partnership, the transaction will be recharacterized as a capital contribution (Reg. Section 1.731- 1(c)(3)).

In contrast to the situation in which a sale is recharacterized as a capital contribution, a contribution of property by a partner to a partnership may be recharacterized as an IRC Section 707(a) sale. IRC Section 707(a)(2)(B) treats certain related transfers of property and distributions as sales between unrelated parties. IRC Section 707(a)(2)(B) is discussed later in this module.

Partner Expenses

Many partners incur unreimbursed expenses while engaged in the partnership's business. Assuming that such expenses are legitimately incurred in the partnership's trade or business, a partner may deduct those expenses to the extent that the partner is expected to pay them without reimbursement from the partnership. This means that the partnership should have a clear policy of what expenses can and will be reimbursed to the partners.

Where there is a partnership agreement provision restricting or limiting reimbursement, or where there is a policy in place limiting reimbursement, the expenses will be deductible by the partner (TAM 9316003). Where a partner could have been reimbursed for the expenses, no deduction is permitted (TAM 9316003, *McLauchlan v. Commissioner*, T.C. Memo 2011-289).

Qualified unreimbursed expenses should be deducted on Schedule E. Not only do such expenses reduce a partner's taxable income, they also reduce self-employment income.

Services Performed by a Partner

IRC Section 707(a) also applies to payments for services performed by a partner for a partnership if the partner is acting as one who is not a partner. If a 50% partner performs services for his partnership, he is taxed on the entire amount of the compensation earned. The fact that half of the compensation is earned by working for himself is ignored.

NOTE

Partners generally report their distributive shares of partnership ordinary income plus any guaranteed payments received for services performed for the partnership as self- employment income subject to the federal self-employment tax. Individuals who are limited partners have self-employment income only if they receive a guaranteed payment as compensation for services performed for the partnership.

Payments to partners for services on a contributing basis or for services performed within the normal scope of a partner's duties generally are not governed by IRC Section 707(a) since the partner is not acting outside his capacity as a partner. In such cases, the payments are treated as IRC Section 707(c) guaranteed payments if they are determined without regard to partnership income.

The primary difference between the taxation of IRC Section 707(a) payments and guaranteed payments under IRC Section 707(c) is the timing of the partner's inclusion of the payments in income. Generally, IRC Section 707(a) payments are included in income by the partner based on the partner's method of accounting. IRC Section 707(c) guaranteed payments are included in income by the partner in the partnership year in which the payments are deducted by the partnership.

EXAMPLE

Guaranteed Payment vs. Independent Contractor Payment

Louie is an attorney in the Troublesome Partnership. Troublesome has a March 31 year-end. Louie provides legal services to Troublesome in November and is paid for the services in December. If Louie is acting in a capacity other than that of a partner, Louie will report the income in the calendar year in which he received it.

If the payment is a guaranteed payment, Louie will report it in the following year, since it will be treated as a guaranteed payment for the year ending the following March 31.

DISGUISED PAYMENTS TO PARTNERS FOR PROPERTY OR SERVICES: IRC SECTION 707(A)(2)

The purposes of IRC Section 707(a)(2) are to distinguish between:

- payments for services or property from allocations and distributions, and
- taxable sales from contributions to and distributions from partnerships.

IRC Section 707(a)(2) recharacterizes certain types of transactions between partners and partnerships so that the transactions are treated as if they occurred between the partnership and an outsider.

Disguised Payments for Services

IRC Section 707(a)(2)(A) provides that when:

- a partner provides services or transfers property to a partnership, there is a related allocation of income or distribution of property to the partner; and
- the transaction viewed as a whole is properly characterized as one between the partnership and a partner acting outside his capacity as a partner, the transaction will be treated as being between the partnership and an outsider.

IRC Section 707(a)(2)(A) applies to transactions that attempt to avoid expense capitalization requirements through allocations of income and corresponding distributions in place of direct payment for property or services. The Senate Committee Report notes that IRC Section 707(a)(2)(A) is designed in part to prevent the current deduction of organization costs and syndication fees.

If the syndicator of a partnership is also a partner, allocations, and distributions to him of partnership income could have the effect of a current deduction of syndication fees. This results since allocation of income to the syndicator or partner reduces income allocated to the remaining partners. When the allocation to the syndicator or partner is followed by an equivalent distribution, it is indistinguishable from a direct payment for syndication fees. The remaining partners, however, have effectively been allowed a current deduction for syndication fees.

Under IRC Section 707(a)(2)(A), a transaction is recharacterized as occurring between a partner and an outsider. The purported distribution to the service partner is treated as a payment for services, and where appropriate, the partnership must capitalize the amount.

The principle of this provision can be illustrated by the following example:

EXAMPLE

Capitalization of Payment for Services

Shirley, an architect, is admitted as a partner to the Lowrise Partnership. The office building constructed by Lowrise is expected to generate income of $100,000 per year. Shirley normally charges $40,000 for the architectural services she performs for Lowrise.

On this occasion, however, Shirley contributes $40,000 cash for a 25% interest in the partnership instead of charging Lowrise for services rendered. Shirley is allocated 25% of the partnership income plus $40,000 of gross partnership income to be paid over a two-year period. The partnership is expected to have sufficient cash available to distribute $20,000 to Shirley in each of the first two years.

Under IRC Section 707(a)(2)(A), the purported income allocation and related partnership distribution to Shirley should be treated as if the partnership had paid an architectural fee to an outsider. Thus, Lowrise must capitalize the fee as part of the construction costs to be recovered through depreciation deductions, rather than as a current operating expense, or an allocation of income, thereby reducing the income allocable to the other partners.

Treasury regulations determine whether a partner is receiving the allocations and distribution in his capacity as a partner. The factors to be considered are as follows:

- Whether the payment is subject to an appreciable amount of risk
- Whether the partner's status is permanent or transitory
- The proximity in time of the performance of service (or transfer of property) and the allocation and distribution
- Whether the recipient partner became a partner primarily to obtain tax benefits for himself or the partnership, which would not have been available if he had performed in a third-party capacity
- Whether the continuing interest in partnership profits is small in relation to the allocation
- Whether the capital account rules under IRC Section 704(b) make income allocations that are disguised payments economically unfeasible and, therefore, unlikely to occur

In last example, the purported allocation and distribution are treated as a payment for services under IRC Section 707(a) because:

- the special allocation to the architect is a fixed-in amount and there is sufficient probability that the partnership will have sufficient gross income and cash to satisfy the allocation and distribution,
- the value of her interest in continuing partnership profits is relatively small in relation to the allocation in question,
- the distribution relating to the allocation is fairly close in time to the rendering of the services, and
- it is not unreasonable to conclude from all the facts and circumstances that the architect became a partner primarily for tax motivated reasons.

PRACTICE POINT

Under Section 199A's final regulations, any Section 707(a)(2) payments to the partner will not be QBI. This can be a problem for entities that have real estate operations in which they have an interest in and manage.

Disguised Sales: Transfers of Money or Property & a Related Transfer of Money or Property to the Contributing Partner

When there is a transfer of money or other property to a partnership and a related transfer of money or other property to the contributing partner, and when viewed together, the transfers are properly characterized as a sale of property, the transaction will be treated as a sale between the partner and the partnership rather than as a contribution of capital.

This provision attempts to overturn case law involving contributions of appreciated property to a partnership followed by subsequent distributions to the contributing partner. These transactions

were used to avoid the recognition of gain by characterizing sales of property to a partnership as capital contributions.

Many different transactions can fall into the trap of being a disguised sale without regard to any intent.

- A partner gets a cash distribution from a partnership upon the contribution of property.
- A partner gets a property distribution from a partnership upon making a cash contribution to the partnership.
- Two or more partners contribute cash and property, then take distributions of property and cash from the partnership.

There is no set format for how these transactions can occur. Thus, the distribution can occur first, or vice versa. The provision applies to any transfer of property where the receipt of the cash or other consideration would not have been made but for the property transfer and the subsequent transfer isn't dependent on the entrepreneurial risks of partnership operations.

The determination of whether there is a disguised sale is based on all of the facts and circumstances, although Reg. Section 1.707-3(b)(2) lists the following as factors indicating a disguised sale.

- The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.
- The transferor has a legally enforceable right to the subsequent transfer.
- The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.
- Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration.
- Any person can loan or agree to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations.
- The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt).
- The partnership holds money or other liquid assets that, beyond the reasonable needs of the business, are expected to be available to make the transfer (taking into account the income that will be earned from those assets).
- That partnership distributions, allocations, or control of partnership operations are designed to affect an exchange of the burdens and benefits of ownership of property.
- The transfer of money or other consideration by the partnership to the partner is disproportionately large in relation to the partner's general and continuing interest in partnership profits.

- The partner has no obligation to return or repay the money or other consideration to the partnership, or the partner has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

Transfers made within two years of a contribution of property are presumed to be a sale of property unless the facts and circumstances clearly establish that the transfers aren't a sale (Reg. Section 1.707-3(c)).

Generally, the nature of the gain (i.e., capital vs. ordinary) will be determined by the gain that would be recognized by the partnership had it sold the property. However, where a partner receiving the distribution holds more than 50% of the partnership's capital or profits interest and the property isn't a capital asset to that partner, ordinary income will result to the partner, no matter what the underlying nature of the assets may be (IRC Section 707(b)(2)).

These gain provisions are subject to a number of exceptions.

- The distribution or payment is a guaranteed payment for capital, provided that the guaranteed payment isn't designed to liquidate all or part of a partner's interest in the partnership rather than provide a return on the capital (Reg. Section 1.707-4(a)(1)(i)).
- The distribution or payment is a reasonable preferred return—a preferential distribution of partnership cash flow to the partner based on capital contributed that will be matched by an allocation of income or gain (Reg. Section 1.707-4(a)(2).
- The distribution or payment is for reimbursement of a preformation expenditure, defined as a capital expenditure:
  - incurred within the two-year period prior to the transfer of property by the partner and
  - the reimbursed amount was incurred by the partner for partnership organization or syndication costs or property contributed to the partnership.
- The expenditures qualifying for this exception don't have to be incurred by the contributing partner but can come from a predecessor business where the partner incurring the expenditure ended up with the business's assets on liquidation (Rev. Rul. 2000-44).
- Other limitations include the following.
  - The reimbursed capital expenditures can't exceed 20% of the FMV of the property at the date of contribution.
  - The 20% limit doesn't apply if the contributed property's FMV doesn't exceed 120% of the partner's adjusted basis in the property at contribution (Reg. Section 1.707-4(d)).
  - The distribution or payment is an operating cash-flow distribution.
  - The distributions to a partner during the year are not presumed to be guaranteed payments or preferred returns and are not characterized as distributions to the partner acting in a capacity other than as a partner.

- The distributions don't exceed the net cash flow of the partnership multiplied by the lesser of the partner's profit interest in the partnership for the year or over the life of the partnership (Reg. Section 1.707-4(b)(2)).

Reg. 1.707-3(c)(2) and 1.707-8 require disclosure on Form 8275 or Form 8275-R for disguised sales transactions.

LIMITATIONS ON SALES BETWEEN PARTNERSHIPS & CONTROLLING PARTNERS: IRC SECTION 707(B)

As discussed in the previous sections, IRC Section 707(a) governs transactions between partners and partnerships. Generally, if a partner is not acting in his capacity as a partner, a transaction between a partner and his partnership is treated under IRC Section 707(a) as a transaction between the partnership and one who is not a partner. Once a transaction is determined to be a transaction governed by IRC Section 707(a), the limitations of IRC Section 707(b) must be applied.

Disallowance of Loss

IRC Section 707(b)(1) provides that no deduction is allowed for losses from sales or exchanges of property that occur directly or indirectly between:

- a partnership and a person who owns (actually or constructively) more than 50% of the capital or profits interest in the partnership, or
- two partnerships if more than 50% of the capital or profits interest in both partnerships are owned (actually or constructively) by the same persons.

IRC Section 707(b)(1)(A) expands its coverage to apply to sales or exchanges between "a partnership and a person," instead of between "a partnership and a partner." Thus, losses from sales or exchanges between a partnership and a nonpartner are disallowed under IRC Section 707(b)(1)(A) if such nonpartner possesses the requisite ownership through the constructive ownership rules.

Even though IRC Section 707(b)(1) disallows the deduction for loss realized by a seller partner, the basis of the property in the hands of the purchaser-partnership is the partnership's cost. If the partnership resells the property for a gain, the partnership is entitled to offset its gain by the previously disallowed loss.

A significant trap in such transactions is that the partner's basis in the partnership is reduced by the loss, although not below zero for the partner's share of the loss (Rev. Rul. 96-10, 19961 CB 138).

EXAMPLE

Disallowed Loss and Basis in a Related Party Sale

Assume Cal, a 60% partner of the Calmel Partnership, sells land to the partnership for $40,000. Cal's basis in the land is $50,000.

Cal's $10,000 loss is disallowed under IRC Section 707(b)(1). The partnership's basis for the land is $40,000. If the partnership resells the property for $40,000, it recognizes no gain or loss and Cal's previously disallowed loss is lost permanently.

If the partnership resells the land for $52,000, its gain of $12,000 ($52,000 less $40,000) is reduced by the previously disallowed loss of $10,000, leaving $2,000 as the recognized gain.

A sale price between $40,000 and $50,000 would result in no recognized gain or loss.

Under IRC Section 707(b)(1)(B), the same treatment would apply if the sale had occurred between two partnerships and the same partners own directly or indirectly more than 50% of the capital or profits interests of both partnerships.

The term "same persons" need not be related as defined in IRC Section 267. Thus, a partnership owned by four unrelated individuals that sells property to a new partnership created by the same four individuals would run afoul of IRC Section 707(b)(1) (*Christopher Dyess v. Commissioner*, T.C. Memo 1993-219).

Installment Sales

Where depreciable property in the hands of the buyer is sold to a related party, IRC Section 453(g) requires that all gain be recognized in the year of the sale. IRC Section 453(g) also defines related parties to be:

- a partner owning directly or indirectly more than 50% of the capital or profits interest in the partnership,
- a corporation and a partnership if the same taxpayers own more than 50% of the outstanding stock of the corporation (by value) and more than 50% of the capital or profits interest in the partnership, and
- two or more partnerships if the same taxpayers own directly or indirectly more than 50% of the capital or profits interest in the partnerships.

Where the parties can show that there is no tax avoidance, gain deferral will be permitted. Generally, tax avoidance won't exist where there is no significant tax deferral because of the installment sale.

A second trap involves an otherwise allowable installment sale between related parties. In that case, a disposition of the property by the buyer within a two-year period accelerates the recognition of gain by the seller (IRC Section 453(e)). Related parties for this rule are defined both by IRC Section 267(b) and IRC Section 318.

While potentially an onerous rule, there are a number of exceptions that cover quite a few circumstances. Income acceleration won't apply if:

- the disposition occurs because of an involuntary conversion that was unanticipated at the time of the first disposition,
- either party dies,
- there was no tax avoidance in either the first or second disposition, or
- the second disposition is an installment sale with a term equal to or longer than the first disposition.

Like-Kind Exchanges

Like-kind exchanges between partners and partnerships are also subject to disallowance where the property is sold by either party during the two years following the completion of the like-kind exchange. Unless there is clearly no tax avoidance motive, disposition within the two-year period requires gain to be recognized at the date of the second disposition.

If a disposition occurs within the two-year period (or extended period, if applicable), gain is recognized at the time of the disposition (not at the time of the original exchange).

The same exceptions noted previously, with respect to the installment sales rules, including a lack of tax avoidance, will prevent the application of these loss disallowance limitations.

The 2017 Tax Cuts and Jobs Act generally repealed Section 1031 for all but real estate transactions. Even prior to the 2017 Tax Act, exchanges of partnership interests did not qualify. IRC Section 1031(a)(2)(D) prior to its repeal.

Ordinary Income from a Sale

IRC Section 707(b)(2) also limits the general rule of IRC Section 707(a). IRC Section 707(b) (2) provides that gain on the sale of property is ordinary income if:

- the property is not a capital asset in the hands of the transferee or purchaser, and
- the sale is, directly or indirectly, between:
  - a partnership and a person who owns (actually or constructively) more than 50% of the capital or profits interest in the partnership, or
  - two partnerships if more than 50% of the capital or profits interest in both partnerships are owned (actually or constructively) by the same person.

The effect of IRC Section 707(b)(2) is to treat as ordinary income what might otherwise be capital gain. In this respect, IRC Section 707(b)(2) corresponds to IRC Section 1239. IRC Section 1239 treats gain realized on a sale of depreciable property between a taxpayer and 50%-owned entity as ordinary income.

The coverage of IRC Section 707(b)(2) is broader than that of IRC Section 1239. IRC Section 707(b)(2) applies to any property that is not a capital asset in the hands of the transferee. IRC Section 1239 applies only to property that is depreciable in the hands of the transferee.

In determining a partner's ownership of capital and profits for purposes of both IRC Section 707(b)(1) and IRC Section 707(b)(2), the constructive ownership rules of IRC Section 267(c) apply. A partner constructively owns his proportionate share of any partnership interests owned by or for a corporation, other partnership, estate, or trust in which he has an interest.

Additionally, a partner constructively owns any partnership interest that is directly or indirectly owned by or for any member of his family. For this purpose, family members include his spouse, brothers, sisters, ancestors, and lineal descendants. An interest constructively owned through family members is not again attributed to another person.

The regulations under IRC Section 267 may apply to sales at a loss between nonpartners and partnerships. If the nonpartner is related to one or more of the partners, the sale is treated as occurring between the nonpartner and each partner separately. Losses attributable to the portion of the sale made to related parties are disallowed. This treatment of transactions between partnerships and nonpartners is more restrictive than the treatment of transactions between partnerships and partners under IRC Section 707(b).

Where there is a nonpartner who indirectly owns 50% or less of the partnership (through attribution), a proportionate loss disallowance rule applies. In this case, a proportionate share of the loss is not permitted. For example, the spouse of a 25% partner could sell property to the partnership at a loss. However, 25% of the loss would be disallowed. When the partnership subsequently sells the property, the disallowed loss will be permitted to reduce the gain recognized on the sale.

While this problem can be avoided by having the nonpartner gift the property to the partner, since a noncontrolling partner's sale of property isn't affected by this disallowance rule, the ability to reduce the gain recognized on a subsequent sale is lost because the basis to the partner on the gift would be the lesser of the donor's basis or FMV. Another potential problem with this course of action is that the IRS could argue such a transaction should be subjected to the anti-abuse rules.

EXAMPLE

Related Party Sale

Frank sells investment property with a basis of $35,000 to a partnership for its FMV of $27,000. The loss on the sale is $8,000 ($35,000 less $27,000). The partnership is owned 30% by Frank's father and 70% by an unrelated party.

The sale is treated as if Frank sold 30% of the property to his father and 70% to an unrelated person. Thus, $2,400 (30% of $8,000) of the loss is disallowed and Frank has a reportable loss of $5,600 (70% of $8,000). If the property is sold at a gain in the future, Frank's father may use the $2,400 disallowed loss to offset his share of the gain.

EXAMPLE

Related Party Sale vs. Minority Partner Sale

If the wife of a 10% partner sells property to the partnership at a loss, 10% of her loss is disallowed under Reg. Section 1.267(b)-1(b)(1). The transaction is treated as if she sold 10% of the property to her husband.

If, on the other hand, the husband sells property to the partnership, he is entitled to recognize any loss on the sale since IRC Section 267 would not apply. IRC Section 707(b) also would not apply as the requisite ownership (50%) is lacking.

MATCHING OF INCOME & DEDUCTIONS IN A TRANSACTION BETWEEN RELATED PARTIES: IRC SECTION 267

IRC Section 267(a)(2) prevents an accrual method payor from deducting amounts owed to a related cash-method payee until the accrued amount actually is paid. Its purpose is to require a matching of income and deductions in transactions between related taxpayers.

At one time, IRC Section 267(a)(2) did not apply to transactions between partners and partnerships. No such matching rule was required by IRC Section 707(a). IRC Section 267(e) makes partnerships and related parties subject to the matching rules of IRC Section 267(a)(2). Thus, an IRC Section 707(a) payment is deductible by the partnership and includable by the partner based on the partner's method of accounting.

IRC Section 267(a)(2) does not apply to IRC Section 707(c) guaranteed payments. As discussed later in this chapter, an IRC Section 707(c) payment is deductible by the partnership and includable by the partner based on the partnership's method of accounting.

EXAMPLE

Section 707(a) Payment

Rick and Gail, both cash-method taxpayers, form an accrual basis partnership. In addition to his distributive share of partnership income, Rick is to receive 5% of the partnership's gross income for his services to the partnership.

If the 5% payment to Rick is an IRC Section 707(a) payment received other than in his capacity as a partner, it would be deductible by the partnership and includable by Rick in the year he receives the payment.

If the payment is an IRC Section 707(c) guaranteed payment, it would be deductible by the partnership and includable by Rick in the year in which the deduction is accrued by the partnership.

GUARANTEED PAYMENTS: IRC SECTION 707(C)

Payments made by a partnership to a partner for services rendered in her capacity as a partner and for interest payments made with respect to contributed capital are not governed by IRC Section 707(a). Such payments are taxed as IRC Section 707(c) guaranteed payments if they are determined without regard to partnership income.

To summarize, in order to qualify as an IRC Section 707(c) guaranteed payment, the payment must:

- be made to a partner in her capacity as a partner;
- be payable in all events, regardless of partnership income, and determined without references to partnership income; and
- not be an IRC Section 731 partnership distribution.

Timing of Deduction & Income Inclusion

The primary difference between an IRC Section 707(a) payment and an IRC Section 707(c) guaranteed payment is the timing of the deduction to the partnership and the inclusion of the income to the partner. "A partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting" (Reg. Section 1.7071(c)).

An IRC Section 707(c) guaranteed payment is deductible by the partnership and includable by the partner based on the partnership's method of accounting. A cash-method partner must recognize a guaranteed payment accrued and deducted by his accrual method partnership even though he has not

yet received the payment. An IRC Section 707(a) payment is deductible by the partnership and includable by the partner based on the partner's method of accounting (IRC Section 267(a)(2)).

Definition of a Guaranteed Payment

Guaranteed payments are defined in IRC Section 707(c) as payments to a partner in his capacity as a partner for services or for the use of his capital "to the extent determined without regard to the income of the partnership." Neither IRC Section 707(a) nor IRC Section 707(c) applies to payments determined with regard to the partnership income for services rendered or capital provided by a partner in his capacity as a partner. Those payments are treated as distributive shares of partnership income, taxable under the general rules of IRC Section 704.

EXAMPLE

Payments with Regard to Partnership Income

Tony is a 50% partner in partnership AB. For services rendered in his capacity as a partner, he is to receive the first $10,000 of partnership net income (in addition to his 50% distributive share) in a year in which the partnership has $100,000 net income.

Since the $10,000 is determined with regard to the partnership net income, it is not guaranteed payment. Under IRC Section 704, Tony has a $55,000 distributive share ($10,000 plus half of remaining $90,000) of partnership income. IRC Section 731 governs any cash actually distributed to Tony.

An amount is not an IRC Section 707(c) guaranteed payment unless it is payable in any event, regardless of whether it exceeds the partnership's net income. For example, an agreement to pay a partner a specified amount per year only in years in which the partnership's net income is equal to or exceeds the specified amount does not create an IRC Section 707(c) guaranteed payment.

Distinguishing from Distributions

Guaranteed payments must also be distinguished from partnership distributions under IRC Section 731. A limited partner may be guaranteed a distribution equal to a percentage of her initial capital contribution. If the distribution reduces the partner's capital account, it is a return of capital and treated as a distribution under IRC Section 731.

The payment is a return on capital if it is not debited to the partner's capital account. In that case, the payment is treated as an IRC Section 707(c) guaranteed payment as payment for the use of the partner's capital. The payment would be includable in income by the partner and deductible by the partnership in the year paid or accrued by the partnership depending on its method of accounting.

Nature of Income & Deduction

IRC Section 707(c) guaranteed payments are includable in the recipient partner's gross income under IRC Section 61(a) as payments received for services or the use of capital. This is the case regardless of the amount or character of partnership income. The partner is taxed on the amount of the guaranteed payment as ordinary income even though the partnership has no taxable income or its income consists only of capital gain. The partner must include the payment in income based on the partnership's method of accounting. A cash-method partner must recognize a guaranteed payment accrued and deducted by his partnership even though he may not yet have received the payment.

From the partnership's side of the transaction, guaranteed payments are generally deductible when paid or accrued under the partnership's method of accounting. If the payment represents a capital cost or nondeductible amount, the partnership is not allowed to deduct the payment currently, but it must capitalize or otherwise account for the payment appropriately.

Impact on Partnership Allocations

A guaranteed payment ordinarily does not affect the computation of the partners' distributive shares. Guaranteed payments may result in the recipient partner reporting ordinary income and other partners reporting ordinary loss from the partnership.

EXAMPLE

Consequences of a Guaranteed Payment

Max receives $100,000 for services rendered to the Noloss Partnership in his capacity as a partner. The payment represents a deductible expense to the partnership. Max's distributive share of partnership profits and losses is 40%.

Noloss's ordinary income before deducting Max's guaranteed payment is $60,000.

The $100,000 is a guaranteed payment since it is payable regardless of the partnership's net income. The partnership's taxable loss after taking into account the guaranteed payment is $40,000.

Allocations to the partners would be as follows:

	Max	Barb	Total
Guaranteed Payment	$100,000	$0	$100,000
Distributive Share of Partnership Net Loss	–16,000	–24,000	–40,000
Total Ordinary Income (Loss)	$84,000	–$24,000	$60,000

An IRC Section 707(c) guaranteed payment does not affect the amount or character of partnership items that may be subject to special tax treatment. Capital gain and loss, for example, are computed without regard to the partnership's ordinary income or loss.

EXAMPLE

Guaranteed Payment vs. Capital Gain

Assume that in the above example the partnership income of $60,000 consists solely of long-term capital gain. Even so, Max's $100,000 guaranteed payment is entirely ordinary income to him. The guaranteed payment is not deductible by the partnership against its capital gain.

The entire capital gain flows through to the partners as a separately reported item under IRC Section 702(a)(2). The guaranteed payment generates partnership net ordinary loss of $100,000 ($0 ordinary income less $100,000 payment).

Allocations to the partners would be as follows:

	Max	Barb	Total
Guaranteed Payment	$100,000	$0	$100,000
Distributive Share of Partnership Net Loss	–$16,000	–$24,000	–$40,000
Total Ordinary Income (Loss)	$84,000	–$24,000	$60,000

Percentage of Income Payments

Another issue involves a guaranteed payment that is determined by taking a percentage of income. The Tax Court has held that allocations of gross income are not guaranteed payments in *Pratt v. Commissioner*, 64 T.C. 203 (1975), affd., 550 F.2d 1023 (CA5, 1977).

However, the IRS has refused to follow this ruling and will treat allocations of gross income as guaranteed payments (Rev. Rul. 81-300, 1981-2 C.B. 143). In the ruling, the IRS concluded a payment of a percentage of gross income will be a guaranteed payment if it is compensation, not a share of profits, based on the facts and circumstances of the case. Those facts include the reasonableness of the payment, whether or not the computation method produces the same results approximating what reasonable compensation to an unrelated party would be. However, Congress revisited the topic in 1984 and concluded that "the payment in Rev. Rul. 81-300 should be recharacterized as a Section 707(a) payment. . . . Accordingly, the Treasury Department and the IRS are obsoleting Rev. Rul. 81-300. . . ." See 80 FR 43652-43661,

While before 2018 this likely would not have a significant impact, the addition of the qualified business income deduction found at IRC Section 199A makes this distinction important. Guaranteed payments are not qualified business income (see IRC Section 199A(c)(4) (B)), but a special allocation, if otherwise qualified, would be eligible to be treated as qualified business income.

A payment based upon net income will likely not be a guaranteed payment since the amount of the payment will be dependent on the partnership's income and, therefore, by definition, is not a guaranteed payment. Where, however, a payment is based on the greater of a fixed amount or a percentage of the partnership's net income (obviously computed before any deduction for the guaranteed payment), some, all, or none of the payment may be a guaranteed payment.

The determination of how much, if any, of a fixed or percentage payment qualifies as a guaranteed payment can be illustrated by an example. Assume that a 25% partner provides substantial services to the partnership. In exchange for those services, the partnership provides that the partner will receive the greater of $30,000 or 30% of the partnership's taxable income before the deduction for the guaranteed payment. The formula is reasonable and comparable with compensation paid to unrelated parties.

Various scenarios create different answers:

- None of the amount is a guaranteed payment. Partnership income is $200,000. The payment will be $60,000 (the greater of 30% × $200,000 or $30,000). Since the payment exceeds the minimum payment of $30,000, none of the payment is a guaranteed payment, not even the amount of the minimum payment.
- All of the payment is a guaranteed payment. Partnership has a loss of $30,000. The payment will clearly be the $30,000 minimum payment. All of this payment will be treated as a guaranteed payment.
- Some of the payment is a guaranteed payment. Partnership income is $60,000. The payment will be $30,000 (the greater of 30% × $60,000 or $30,000). Of the $30,000 payment, $18,000 is treated as the partner's distributive share of partnership income and $12,000 is a guaranteed payment.

Self-Employment Tax Issues

Guaranteed payments generally represent self-employed income to the partner. Even a partnership renting real estate could be engaged in a trade or business, thereby causing the payment of a guaranteed payment to a partner to create self-employment income. That determination will be based on all of the facts and circumstances. Limited partners are also generally exempt from the self-employment tax on guaranteed payments, unless a limited partner provides services to the partnership and the payment of the guaranteed payment is really compensation for those services (IRC Section 1402(a)(13)).

EMPLOYEE STATUS

Some questions exist regarding whether a partner can be an employee of the partnership, receiving a W-2 rather than a K-1. The IRS's answer, for many years, has been *no*. This issue can be important due to the limitation based on W-2 wages for qualified business income under IRC Section 199A. One of the limitations on the IRC Section 199A deductions is a limitation based upon the wages paid to employees. Guaranteed payments to partners, even though paid for services, are not considered wages for purposes of the Section 199A deduction.

Statutory Provisions

The statutory basis for any discussion begins with IRC Section 707(a)(1).

> If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

On its face, this seems to answer the question. IRC Section 707(a)(2) goes on to provide the following:

> Under regulations prescribed by the Secretary . . . if a partner performs services for a partnership . . . there is a related direct or indirect allocation and distribution to such partner and . . . the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a

> transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1) (not in his capacity as a partner).

Then there's IRC Section 707(c), which reads as follows:

> To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of IRC Section 61(a) (relating to gross income) and, subject to IRC Section 263, for purposes of IRC Section 162(a) (relating to trade or business expenses).

Unfortunately, the legislative history is silent on the issue of whether or not IRC Section 707 can be read to include an employer-employee relationship for partnerships. Thus, the answer has to lie in other areas. Of interest, though is the discussion in the general explanation of the Deficit Reduction Act of 1984. There, the test seems to be whether a profit is assured or not. If a profit is assured, no matter what the partnership does, then the individual is not acting as a partner.

IRS Guidance

The IRS takes a much different view, however. In two rulings, the IRS held that a partner couldn't be an employee. The first, Rev. Rul. 69-184, is a very short, three-sentence ruling. It simply holds that a partner can render services as a partner or as an independent contractor, period. The ruling provides no analysis and no citations for the IRS's position, only the conclusion.

Rev. Rul. 69-184's conclusion was reinforced in Rev. Rul. 72-596, in which the IRS concluded that workmen's compensation premiums on partners weren't deductible since partners couldn't be employees. In Notice 2005-8, 2005-1 C.B. 368, the IRS indirectly signaled it hadn't changed its position by citing Rev. Rul. 691-84 in holding that contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to the HSA of an employee.

The IRS in 2016 signaled its position had not changed on this matter. See the following discussion of this issue of partnerships owning disregarded entities.

Partnership Owning a Disregarded Entity That Hires the Partners

If a partnership owns an LLC it treats as a disregarded entity under the check-the-box rules, may partners of the partnership be treated as employees of the disregarded entity, receiving a W-2 and obtaining certain tax beneficial fringe benefits open to employees but not partners? The IRS says the answer has always been no, but since some read the existing regulations otherwise the agency issued in 2016 Temporary Reg. Section 301.7701-2T (e)(8)(i) (TD 9766) and an identical proposed regulation (REG114307-15).

The "check-the-box" provisions found in Reg. Section 301.7701-2 were created to deal with state law entities that had no direct equivalent under federal law (with the prime example being limited liability companies (LLCs)). Under those rules, the taxpayer elects to treat the entity as if it was an entity the IRC has a treatment for, picking from a list that depends on the number of owners.

But this pretend treatment of an entity as something it really isn't sometimes creates issues, which the IRS quickly discovered when dealing with payroll taxes and such entities—leading the IRS to create a

modified set of rules for payroll tax issues and entities that elected disregarded treatment. The problem was that, under state law, any liabilities of those entities did not leak out to owner.

The treatment of disregarded entities under the check-the-box regulations is different for income and payroll taxes as explained in the preamble to the temporary regulations.

> Section 301.7701-2(c)(2)(i) states that, except as otherwise provided, a business entity that has a single owner and is not a corporation under Section 301.7701-2(b) is disregarded as an entity separate from its owner (a disregarded entity). However, Section 301.7701-2(c)(2)(iv)(B) provides that an entity that is a disregarded entity is treated as a corporation for purposes of employment taxes imposed under subtitle C of the Internal Revenue Code (Code).
>
> Therefore, the disregarded entity, rather than the owner, is considered to be the employer of the entity's employees for purposes of employment taxes imposed by subtitle C.

But the "lack of liability leakage" problem isn't really a problem for self-employment taxes, since there the liability would not exist for the LLC but rather the entity owning the interest. So, the IRS sought to add more clarification that held that for self-employment tax purposes, the income tax treatment would apply (i.e., total disregard of the entity).

But the example in the regulations explaining the application of the self-employment tax rule only discussed the case of a sole proprietor. This led some practitioners to take the position that a partner could be an employee of an LLC owned 100% by the partnership.

The IRS notes the following in the preamble:

> Under this reading, which was not intended, some taxpayers have permitted partners to participate in certain tax-favored employee benefit plans. The Treasury Department and the IRS note that the regulations did not create a distinction between a disregarded entity owned by an individual (that is, a sole proprietorship) and a disregarded entity owned by a partnership in the application of the self-employment tax rule. Rather, Section 301.7701- 2(c)(2)(iv)(C)(2) provides that the general rule of Section 301.7701-2(c)(2)(i) applies for self- employment tax purposes for any owner of a disregarded entity without carving out an exception regarding a partnership that owns such a disregarded entity. In addition, the Treasury Department and the IRS do not believe that the regulations alter the holding of Rev. Rul. 69-184, 1969-1 CB 256, which provides that: (1) bona fide members of a partnership are not employees of the partnership within the meaning of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages (chapters 21, 23, and 24, respectively, subtitle C, Internal Revenue Code of 1954), and (2) such a partner who devotes time and energy in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer- employee relationship, has the status of an employee.

Specifically, the IRS adds the following language to the end of Reg. Section 301.7701-2T(c)(2)(iv)(C)(2):

> Also, if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under Section 301.7701-2, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under Section 301.7701-2 is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under Section 301.7701-2.

Interestingly, while the IRS insists this is how the regulation always should have been applied, the agency is providing an effective date for this provision, indicating it is meant to give time to partnerships to make adjustments to payroll and benefits plans. Explaining Temporary Reg. Section 301.7701-2(e)(8)'s transition rule, the preamble provides the following:

> In order to allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, these temporary regulations will apply on the later of: (1) August 1, 2016, or (2) the first day of the latest-starting plan year following May 4, 2016, of an affected plan (based on the plans adopted before, and the plan years in effect as of, May 4, 2016) sponsored by an entity that is disregarded as an entity separate from its owner for any purpose under Section 301.7701-2. For these purposes, an affected plan includes any qualified plan, health plan, or Section 125 cafeteria plan if the plan benefits participants whose employment status is affected by these regulations. For rules that apply before the applicability date of these regulations, see 26 CFR part 301 revised as of April 1, 2016.

The last line may raise some concern since the IRS did not explicitly bless the treatment prior to that date and the inclusion of nonemployees in many of those plans could result in a qualification issue. Presumably, though, based on language before that sentence, the IRS plans to not push the issue unless the agency finds a set of bad facts.

Judicial Rulings

While some may have questioned the logic of the IRS's view, few have actually ended up taking the issue to court. Few courts have addressed this issue, but when they have, the courts have been more flexible in their willingness to provide employee status to partners, although the most recent case showed a willingness to accept the IRS's view. However, all of the case law predates the IRS's 2016 regulations discussed earlier and, thus, we do not have a court looking at whether the IRS regulation itself is a reasonable interpretation of the law in this area.

Probably the case most on point is *Armstrong v. Phinney*, 394 F.2d, 661 (CA5, 1968). There, the 5th Circuit, in a not-so-well-reasoned opinion, held that the IRC Section 119 lodging exclusion was available to a partner because a partner could be both a partner as well as an employee in an employer-employee relationship.

The Tax Court still hasn't directly addressed this issue. However, in two cases, the court acknowledged in dicta that a partner could be an employee (*Kobernat v. Commissioner*, T.C. Memo

1972-132 and *Russell v. Commissioner*, T.C. Memo 1982-709). These cases, though generally dealt with using IRC Section 119, are much like the Armstrong case.

In a more recent case, though, a U.S. District Court indicated acceptance of Rev. Rul. 69-184's conclusions without commenting on its justification (or, more correctly, lack thereof) for its conclusion. In the case of *Riether v. United States*, 112 AFTR 2d 2013-6074 (DC NM, 2012), the court concluded:

> [p]laintiffs should have treated all the LLC's income as self-employment income, rather than characterizing some of it as wages. Revenue Ruling 69-184 says "members of a partnership are not employees of the partnership" for purposes of self-employment taxes. [Rev. Rul. 69- 184, 1969-1 C.B. 256]. Instead, a partner who participates in the partnership business is "a self-employed individual." Id. Because Plaintiffs did not elect the benefits of corporate-style taxation under Treasury Regulation Section 301.7701-3(a), they should not have treated themselves as employees in distributing the remaining $51,500 of the LLC's income.

What Is an Adviser to Do?

As a reader, you can fairly protest that this discussion has raised more questions than it has answered. While that criticism is fair, reality is that the situation truly is this unclear. But Forms 1065, 941, and W-2 do need to be filed, so a position has to be taken by the partnership.

From a practical perspective, advisers will find that a number of individuals in a partnership may wish to be treated as an employee, not for any tax benefit, but simply because they find paying estimated taxes too bothersome or confusing and want to have a paycheck so that taxes can be withheld. In the author's experience, this issue has far more often caused the "partner as an employee" discussion to come up than any potential tax benefit that might be available only to employees.

So, questions arise: Can the advisers advise a partnership that it can treat a partner (or partners) as an employee? And, if the partnership does so, can the adviser sign the tax return? And if the adviser can sign the return, would disclosure be required both to avoid preparer penalties and protect the partnership against IRS penalties?

There are valid arguments on either side of this issue. IRC Section 707(a) clearly suggests that an employment relationship is possible. However, the IRS is convinced that any compensation for a partner's services must be made as guaranteed payments. Given the current enforcement mentality in the IRS, a practitioner should strongly consider disclosing the fact that a partner is treated as an employee if the client desires to take that position. As the position is now arguably contrary to a regulation, that likely means filing Form 8275-R with the return.

The only other consideration would be the assessment of the reckless or willful disregard penalty under IRC Section 6694(b) (greater of $5,000 or 50% of the tax preparation fee). Reg. Section 1.6694-3(c) provides that a position contrary to a published revenue rule or notice could subject the preparer to the IRC Section 6694(b) penalty. However, Reg. Section 1.6694-3(c) also provides that there is no reckless or willful conduct if the position taken, even though contrary to a revenue rule or notice, meets the substantial authority standard in Reg. Section 1.6662-4(d).

Steps that might help a position that a partner is an employee, independent of her status as a partner, include the following.

- Have an employment agreement that has commercially reasonable terms and is similar to other employment agreements for employees similarly situated.

- The partnership should be able to fire the employee or partner, and that should be separate and distinct from any termination provisions in the LLC agreement.

- Treat the partner or employee as an employee for all employment purposes (i.e., if time clocks are used, have the partner or employee clock in; if random drug testing is done, have the partner or employee in the pool).

- Pay the employee or partner on the normal payroll schedule, not on a draw schedule.

FRINGE BENEFITS

A partner is generally precluded from the receipt of many of the traditional tax-free fringe benefits available to an employee. Assuming the partner is truly not an employee or the partnership decides that it does not want to take a position contrary to the IRS's stated position, it's important to understand the impact of these limitations.

A list of some of the more important benefits and their treatment follows.

- IRC Section 106 health insurance premiums are generally taxable to a partner as a guaranteed payment (Rev. Rul. 91-26, 1991-1 C.B. 184).

- IRC Section 223 HSA contributions to a partner are treated as distributions under IRC Section 731 or guaranteed payments under IRC Section 707(c) (Notice 2005-8, 2005-1 C. B. 368).

- IRC Section 125 cafeteria plan regulations specifically exclude self-employed individuals (Proposed Reg. Section 1.125-1).

- IRC Section 119 employer-provided meals and lodging are generally viewed as being taxed to partners. However, see the Armstrong case, cited earlier.

- IRC Section 79 group term life insurance premiums aren't excludable (Reg. Section 1.79-0 and Reg. Section 31.3401(c)-1(e)).

- IRC Section 127 educational assistance programs are severely limited (not more than 5% of the benefits) for more than 5% owners, including partners (IRC Section 127(b)(3)).

- IRC Section 129 dependent care plan benefits are available to partners tax-free (IRC Section 129(e)(3)).

- IRC Section 120 employer-provided legal services are available to partners tax-free (IRC Section 120(d)).

- IRC Section 132 statutory fringe benefits are a mixed bag.

  - Partners who perform services can receive no-additional-cost services, qualified employee discounts, de minimis fringe benefits, and working condition fringe benefits tax-free (Reg. Section 1.132-1(b)).

- For partners to qualify for tax-free treatment, the no-additional-cost services and qualified employee discounts must be nondiscriminatory (IRC Section 132(j)(1)).

The remaining IRC Section 132 fringe benefits don't specifically address the issue of whether partners may receive them tax free (Congress passed them after the regulations defining who could receive them tax free were promulgated), but it seems logical to conclude that the expanded employee definition provided by the regulations would apply to these as well. However, qualified transportation fringe benefits remain complicated.

SUMMARY

IRC Section 707 governs transactions between partners and partnerships. Payments to partners can be divided into two broad categories:

- Payments received by the partner "other than in his capacity as a partner"
- Payments received by the partner "in his capacity as a partner"

Under IRC Section 707(a), payments received by the partner other than in his capacity as a partner are treated as if the partnership engaged in a transaction with an unrelated third party. These transactions are subject to the limitations of IRC Section 707(b) relating to sales and exchanges between a partnership and its partners and the matching of income and deduction rules of IRC Section 267.

Payments received by the partners in their capacity as partners can be subdivided into two categories:

- Guaranteed payments
- Payment on distributive shares

If a partner is acting in his capacity as a partner and the payment to the partner for services or for the use of capital are made without regard to the partnership income, the payment will be treated as a guaranteed payment under IRC Section 707(c). If the partner is acting in his capacity as a partner but the payment is dependent on partnership income, the payment will be treated as a distributive share of partnership income under IRC Section 704, and the actual cash payment to the partner is treated as a partnership distribution under IRC Section 731.

NOTES

Unit

7

Transfers of Partnership Interests

LEARNING OBJECTIVES

- **Calculate** gain or loss on the sale or exchange of a partnership interest.
- **Determine** the character of the gain or loss.
- **Recognize** hot assets.
- **Report** dispositions of partnership interests.

INTRODUCTION

A partner's interest in a partnership is an asset subject to disposition just as any other asset. As a general rule, a partnership interest is a capital asset so that any gain or loss recognized on its disposition is capital gain or loss (IRC Section 741). The unique blend of entity and aggregate concepts of partnership taxation requires departure from the general rules and further consideration.

The common methods of disposing of an interest in a partnership include:

- sale or exchange,
- gift,
- charitable contribution,
- abandonment or forfeiture, and
- liquidation.

Liquidation is dealt with in another unit. Each of the other methods is discussed in this unit.

SALE OR EXCHANGE

When a partner sells an interest in a partnership, the issues to be resolved are the amount of gain or loss to be recognized and the character of that gain or loss.

Amount of Gain or Loss

As with the sale of any other asset, the amount of gain or loss to be recognized on the sale of a partnership interest is the difference between the sales price and the partner's adjusted basis at the date of sale. The sales price includes the partner's share of liabilities (IRC Section 752(d)) as of the date of sale. Liabilities are allocated in the same manner as previously discussed in determining basis.

Often, nonrecourse liabilities exceed the fair market value (FMV) of the underlying property. It has been argued that the excess of such liabilities over the FMV is not a part of the sales price since IRC Section 752(c) limits liabilities assumed to the FMV of the property. The Section 752(c) limitation applies only to transactions between a partner and a partnership and not between a selling partner and a purchasing partner (*Tufts v. Commissioner*, 461 U.S. 300, (1983)).

The basis of the interest being sold is determined as of the date of sale, even though the amount may not be determinable at that date.

EXAMPLE

Determination of Gain or Loss

Buying and selling partners agree that income or loss for both of them is to be determined by allocating partnership income for the year between them based upon the days each owns his interest.

Neither the seller's basis nor his gain or loss on a sale can be determined until the close of the partnership year.

If a partnership agreement calls for income to be distributed currently, it must be determined whether the selling partner is entitled to his distribution or if the purchasing partner is buying the right to that distribution. If the selling partner is entitled to the distribution, his basis at the date of sale should be reduced for the distribution even though he is no longer a partner at the time it is received. Effectively, the partner has sold his partnership interest but retained a receivable from the partnership.

PRACTICAL TIP

This issue is frequently one that arises after the transaction is completed, with both the buyer and seller arguing that the distribution is theirs. The sales agreement or other sales document should include a specific provision dictating how such a distribution is to be treated.

EXAMPLE

Basis for Determination of Gain

Biggain is a general partnership in which the partners share equally. The partners' inside and outside bases are equal, and the partnership books reflect the following on January 1:

	Fair Market Value	Tax Basis
Assets	$60,000	$15,000
Liabilities	$30,000	$30,000
Capital—Moe	$10,000	–$5,000
Capital—Larry	$10,000	–$5,000
Capital—Curly	$10,000	–$5,000
Total Capital and Liabilities	$60,000	$15,000

On September 30, Moe sells his interest to Doris for $12,000 in cash and the assumption of his share of partnership liabilities. Moe and Doris agree that income or loss will be allocated between them based upon periods of ownership. Income for the year is $9,000. Moe receives a distribution from the partnership of $2,250 on February 12 of the following year.

Sales Price	
Cash Paid to Moe	$12,000
Liabilities Assumed	$10,000
Total Sales Price	$22,000

Basis	
Basis at January 1 (1/3 of $30,000-5,000)	$5,000
Income for Year	$2,250
Distributions in Subsequent Year	–$2,250
Basis at Date of Sale	$5,000
Gain on Sale ($22,000 less $5,000)	$17,000

A partnership interest is a capital asset. Gain or loss on disposition of a partnership interest is generally capital in nature. This entity approach, however, would provide partners with the opportunity to convert ordinary income into capital gain.

EXAMPLE

Character of Gain on Sale of a Partnership Interest

Goodbooks is a general partnership in which all partners share equally. Goodbooks is a CPA firm and keeps its books and records on a cash basis. Tara's share of billed but uncollected receivables is $25,000.

If Tara remains in the partnership, the $25,000 will be ordinary income to her when the receivables are collected. Absent limitations on Section 741, she could convert the $25,000 into capital gain if she sells her partnership interest.

The necessary limitations on Section 741 are provided in Section 751.

SECTION 751: "HOT ASSETS"

In General

The amount received in a sale or exchange of a partnership that is attributable to unrealized receivables or appreciated inventory is considered as realized from the sale or exchange of property that is not a capital asset (IRC Section 751(a)). These assets are referred to as "751 assets" or "hot assets."

This provision will apply to distributions as well as sales and exchanges. The hot assets rule is very complicated—so complicated, in fact, that in Notice 2006-14, the IRS announced it was studying the issue to try and reduce the administrative burden that computing the ordinary income and capital gain imposed on taxpayers. As yet, nothing has come of this study.

The definitions on unrealized receivables and appreciated inventory are discussed in the module on distributions. In this module, we look at applying these rules to a transfer of an interest as opposed to when a distribution triggers them.

Calculation of Gain or Loss

When a partner sells her interest in a partnership, it is necessary to calculate:

- total gain or loss,
- gain or loss attributable to hot assets, and
- capital gain or loss.

Since the gain or loss must be allocated between ordinary income assets—the hot assets—and capital gain, the partnership must take the six following steps to determine the partner or partnership's gain.

- Determine FMV and tax basis of hot assets in the hands of the partnership.
- Determine total gain or loss of the selling partner.

- Determine the portion of sale proceeds received by the selling partner allocable to hot assets compared to the partner's allocable share of those assets.
- Determine to portion of the selling partner's basis attributable to hot assets.
- Determine the gain or loss on hot assets.
- Determine the capital gain or loss.

In determining the portion of the sale proceeds attributable to hot assets, an arm's length price negotiated between the buyer and seller will generally be respected (Reg. Section 1.751-1(a) (2)). If there is no such agreement, the amount of sale proceeds attributable to the hot assets is generally that portion of total proceeds allocable to the FMV of the hot assets the seller would receive if the partnership were liquidated in a pro rata liquidation on the date of sale.

The basis attributable to the hot assets is the basis that such assets would have in the hands of the seller if distributed to her by the partnership. This will generally be the lesser of basis of the assets to the partnership or the partner's basis in her partnership interest (Reg. Sections 1.732-1 and 2).

EXAMPLE

Allocation of Gain to Hot Assets

Profitable, LLC is a cash basis partnership in which all partners share equally. Bill sells his interest in the partnership to Mike for $30,000 and the assumption of his share of liabilities. Bill's basis in the partnership is $44,667.

On the date of sale, the balance sheet of Profitable, LLC is as follows:

	Fair Market Value	Tax Basis
Cash	$5,000	$5,000
Unrealized Receivables	$20,000	$0
Inventory	$10,000	$9,000
Land	$90,000	$120,000
Total Assets	$125,000	$134,000
Liabilities	$35,000	$35,000
Capital—Bill	$30,000	$33,000
Capital—Tom	$30,000	$33,000
Capital—Al	$30,000	$33,000
Total Liabilities and Capital	$125,000	$134,000

Step 1: The FMV and tax basis of the hot assets are:

	Fair Market Value	Tax Basis
Receivables	$20,000	$0
Inventory	$10,000	$9,000
Total	$30,000	$9,000

Step 2: The total gain or loss to Bill is determined to be:

Sales Proceeds	
Cash	$30,000
Assumption of Liabilities	$11,667
Total Proceeds	$41,667
A's Basis	$44,667
Total Gain (Loss)	–$3,000

Step 3: Proceeds attributable to Bill's portion of the hot assets are:

Receivables (1/3 of $20,000)	$6,667
Inventory (1/3 of $10,000)	$3,333
Total	$10,000

Step 4: The portion of Bill's basis attributable to the hot assets is:

Receivables	$0
Inventory (1/3 of $9,000)	$3,000
Total	$3,000

Step 5: Bill's ordinary gain or loss on the sale of hot assets is:

Proceeds (Step 3)	$10,000
Inventory (1/3 of $9,000)	3,000
Total	$7,000

The gain is taxed as ordinary income under IRC Section 751(a).

Step 6: Bill's capital gain or loss is:

Total Gain (Loss) (Step 2)	–$3,000
Less: Ordinary Gain (Loss) (Step 5)	$7,000
Capital Gain (Loss)	–$10,000

While the selling partner had an overall loss on the transaction of $3,000 in this example, he must still recognize some ordinary income as the result of the sale of his partnership interest that was attributable to appreciate ordinary income assets.

Economically, the taxpayer received $10,000 of proceeds for his share of unrealized receivables and appreciated inventory. He also received proceeds relating to land that had lost value. His share of the proceeds that related to the land was $30,000 (1/3 of $90,000) compared to his share of the basis of $40,000 (1/3 of $120,000). Therefore, there's a $10,000 long-term capital loss.

Holding Period

In determining the extent to which capital gain recognized on a sale of the interest is to be long or short term, reference must be made to IRC Section 1223. Traditionally, the partner has one basis for the interest; however, that basis may be made up of both short- and long-term holding periods. The Service has issued Reg. Section 1.1223-3 providing the method of allocating gain or loss between short- and long-term recognition. The regulation allocates gain or loss to short and long term in the same proportions as the holding period of the interest, based on the FMV.

Thus, allocations to either short or long term will be based on the following formula:

$$\frac{\text{FMV of the long- or short-term interest immediately after acquisition}}{\text{FMV of the entire interest.}}$$

This is not applicable to distributions from the partnership.

EXAMPLE

Split Gain Because of Holding Period

Jane contributes $10,000 in cash and investment property she has held for three years (basis –$10,000, and FMV – $20,000) to JP partnership for a 50% interest. Her basis in the partnership is $20,000 with a FMV of $30,000.

Her interest in the partnership consists of both short- (cash contributed) and long- (investment property) term holding periods. One-third of her interest in the partnership is short term ($10,000 cash / $30,000 total FMV × $30,000 total FMV) and her long-term interest is 2/3 ($20,000 / $30,000 × $30,000).

Nine months later, she sells her interest for $35,000. Her basis at the time of sale is $15,000 due to the allocation of partnership items. Her gain realized upon the sale, assuming that IRC Section 751 is not applicable, is $20,000. One-third of the gain will be short term and two-thirds will be long term.

The application of this rule can create unexpected problems for partners. Under Reg. Section 1.1223-3, additional capital contributions can create short-term capital gain for the proportionate part of the partnership interest.

EXAMPLE

Split Interest

Lucy has owned a 25% interest in the Rockaway Partnership for five years. The partnership holds only capital assets. Her basis in the partnership is $30,000 and the FMV of her interest is $40,000. In May 2017, Lucy makes an additional $10,000 contribution upon the request of the partnership's manager. In November 2017, Lucy sells her interest for $50,000.

Lucy must split her interest into two parts. The first part, the interest held for five years, will generate long-term capital gain, since her holding period of the interest exceeded one year.

The second, represented by the additional capital contribution in May 2017, will be taxed as short-term capital gain. The computation is as follows:

$$\frac{\text{FMV short term}}{\text{FMV entire}} = \frac{\$10{,}000}{(\$40{,}000 + \$10{,}000)} = 20\%$$

FMV short term = $10,000 = 20%

FMV entire ($40,000 + $10,000)

Accordingly, 20% of the gain will be attributed to the interest deemed to have been acquires in May 2017 when the additional capital contribution was made. The remaining 80% of the gain will be long-term capital gain

Look-Through Rule for Capital Gain

Once the gain has been allocated between short and long, the next issue to be addressed is the rate to apply to the long-term gain as capital gain rates differ. For example, collectibles (28%), Section 1202 stock (14%), and Section 1250 property (25%) all reflect different tax treatments of capital gains. The regulations (Treas. Reg. Sections 1.1(h)-1 and 1.741-1) provide that the various rates also apply to the sale of an interest in a partnership or S corporation that holds assets within the previously mentioned classes of long-term gain.

In general, the amount of gain is determined by a look-through approach that allocates to the selling partner the portion of such gains as if the partnership had sold those assets in a fully taxable transaction at FMV immediately before the transfer of the interest by the partner. This can only apply to the extent of the allocable long-term gain as determined earlier. Any look through loss on a collectible will be ignored for this purpose.

EXAMPLE

Look-Through Rule for Capital Gains

Assume the same facts as Example 6, except that the investment property contributed included a collectible that at the time of sale of the interest had a basis of $3,000 and a FMV of $10,000.

Of the $20,000 gain realized, the recognition will be:

Short term		$6,667
Long term	Long-term collective look-through	$7,000
	Residual long term	$6,333

Installment Sales

A partnership interest can be sold on an installment basis. Installment treatment generally allows the seller to recognize taxable income as cash is received over a period of time. As previously discussed, the selling partner's share of liabilities is included in the selling price and in the amount realized on sale. Relief from those liabilities is considered a cash payment in the year of sale and is included in the contract price as used in IRC Section 453 only to the extent relief of liabilities exceeds the selling partner's basis in his partnership interest (Reg. Section 1.453-4(c)).

The installment sales rules require recapture income under IRC Sections 1245 and 1250 to be included in income in the year of sale, even if no payments are received in that year (IRC Section 453(l)). To the extent the sale of a partnership interest included ordinary income relating to recapture, the sale is bifurcated. The recapture income is reported currently. Capital gain or Section 1231 gain is deferred. Even this Section 1231 gain can be recharacterized as ordinary income to the extent of any Section 1231 losses claimed within the past five years.

Generally, the sale of personal property that constitutes inventory in the hands of the seller is not permitted installment sale treatment (IRC Section 453(b)(2)(B)). While the issue has never been addressed, the sale of a partnership interest that includes inventory would presumably have treatment similar to that accorded IRC Section 1245 property. That portion of the gain would be reported in the year of sale irrespective of actual sales proceeds.

Tiered Partnership

When a partner sells an interest in an upper-tier partnership, the determination of hot assets and the resulting classification of income or loss from the sale is made as if the upper-tier ("parent") partnership directly owned its proportionate share of the assets of any lower-tier ("subsidiary") partnership (IRC Section 751(f)). No regulations have been issued. The general approach of IRC Section 751 presumably applies to determine the amount of sales proceeds and basis attributable to the lower-tier assets.

Reporting Requirements

Sale or exchange of an interest in a partnership owning hot assets gives rise to a circular reporting requirement. First, the transferor partner is required to notify the partnership. The partnership must then complete Form 8308, Report of Sale or Exchange of Certain Partnership Interests. Copies must be furnished to both the transferor and transferee partners on or before January 31 following the calendar year in which the transfer occurs.

The partnership is also required to attach Form 8308 to its Form 1065 for the year in which the disposition occurred (IRC Section 6050K). Information required on Form 8308 is:

- name, address, and TIN of the partnership;
- name, address, and TIN of the transferor;
- name, address, and TIN of the transferee; and
- date of sale of exchange.

The transferor is required to attach a statement to his income tax return containing the:

- date of sale or exchange,
- transferor's adjusted basis for the interest,
- portion of the transferor's basis attributable to hot assets,
- amount of sales proceeds received or to be received for the interest, and
- portion of those proceeds attributable to hot assets.

A copy of Form 8308 is reproduced in the following figure.

Form **8308**
(Rev. September 2018)
Department of the Treasury
Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

► Go to *www.irs.gov/Form8308* for the latest information.

OMB No. 1545-0123

Name of partnership	Phone number	**Employer identification number**
Number, street, and room or suite no. If a P.O. box, see instructions.		
City or town, state or province, country, and ZIP or foreign postal code		

Part I **Transferor Information** (Beneficial owner of the partnership interest immediately before the transfer of that interest)

Name	**Identifying number**
Number and street (including apt. no.)	
City or town, state or province, country, and ZIP or foreign postal code	

Notice to Transferors: *The information on this form has been supplied to the Internal Revenue Service. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.*

Statement by Transferor: *The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to his or her return. See* Instructions to Transferors *for more details.*

Part II **Transferee Information** (Beneficial owner of the partnership interest immediately after the transfer of that interest)

Name	**Identifying number**
Number and street (including apt. no.)	
City or town, state or province, country, and ZIP or foreign postal code	

Part III **Date of Sale or Exchange of Partnership Interest ►** ____/____/____

Sign here only if you are filing this form by itself and not with Form 1065

Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

► Signature of partnership representative or partner or limited liability company member ► Date ____/____/____

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of form. Form 8308 is filed by a partnership to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items (that is, where there has been a section 751(a) exchange).

Who must file. A partnership must file a separate Form 8308 for each section 751(a) exchange of an interest in such partnership. See Regulations section 1.6050K-1.

Note: Form 8308 does not have to be filed if, under section 6045, Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, is required to be filed with respect to the sale or exchange.

A partnership must file Form 8308 once the partnership has notice of the section 751(a) exchange. The partnership has such notice when either:

1. The partnership receives written notification of the exchange from the transferor that includes the names and addresses of both parties to the exchange, the identifying numbers of the transferor and (if known) of the transferee, and the date of the exchange; or

2. The partnership has knowledge that there has been a transfer of a partnership interest and, at the time of the transfer, the partnership had any unrealized receivables or inventory items.

No returns or statements are required under section 6050K if the transfer was not a section 751(a) exchange. For example, a transfer which in its entirety constitutes a gift for federal income tax purposes is not a section 751(a) exchange.

A partnership may rely on a written statement from the transferor that the transfer was not a section 751(a) exchange unless the partnership has knowledge to the contrary. If a partnership is in doubt whether partnership property constitutes unrealized receivables or inventory items or whether a transfer constitutes a section 751(a) exchange, the partnership may file Form 8308 to avoid the risk of incurring a penalty for failure to file.

When to file. Generally, file Form 8308 as an attachment to Form 1065 for the tax year of the partnership that includes the last day of the calendar year in which the section 751(a) exchange took place. Form 8308 is due at the time for filing the partnership return, including extensions.

If, however, a partnership is notified of a section 751(a) exchange after it has filed its partnership return, file Form 8308 separately, within 30 days of notification, with the service center where Form 1065 was filed.

Copies of Form 8308 to be furnished to transferor and transferee. All partnerships required to file Form 8308 must furnish a copy of the form to each transferor and transferee by January 31 of the year following the calendar year in which the section 751(a) exchange occurred or, if later, 30 days after the partnership has notice of the exchange.

If the partnership does not know the identity of the beneficial owner of an interest in the partnership, the record holder of the interest is treated as the transferor or transferee.

Cat. No. 62503I Form **8308** (Rev. 9-2018)

Note: The transferor of the interest is required to notify the partnership of the exchange of the partnership interest unless, under section 6045, Form 1099-B is required to be filed.

Form 8308 must generally be prepared prior to the time it must be attached to the partnership return and sent to the IRS. This will allow the timely furnishing of Forms 8308 to the transferor and transferee.

Instructions to Transferors

This form alerts transferors that they are required to treat a portion of the gain realized from a section 751(a) exchange as ordinary income. For more details, see Pub. 541.

Separate statement required by transferor. The transferor is required by Regulations section 1.751-1(a)(3) to attach a statement to the transferor's income tax return for the tax year of the sale or exchange with the following information.

1. The date of the sale or exchange.

2. The amount of any gain or loss attributable to the section 751 property.

3. The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

Instructions to Partnerships

Section 751(a) exchange. A section 751(a) exchange occurs when money or any property is exchanged for all or part of a partnership interest that is attributable to unrealized receivables or inventory items. Generally, any sale or exchange of a partnership interest (or any portion) at a time when the partnership has any unrealized receivables or inventory items is a section 751(a) exchange.

Unrealized receivables. Unrealized receivables, to the extent not previously includible in income under the partnership's accounting method, are any rights to payment for:

1. Goods delivered or to be delivered, to the extent that the payment would be treated as received for property other than a capital asset; and

2. Services rendered or to be rendered.

Unrealized receivables also include the amount of gain that would be ordinary income if any of the following types of partnership property were sold on the date of the section 751(a) exchange.

- Mining property (section 617(f)(2)).
- Stock in an interest charge domestic international sales corporation (section 992(a)).
- Farm recapture property or farm land (section 1252(a)).
- Franchises, trademarks, or trade names (section 1253(a)).
- Oil, gas, or geothermal property (section 1254).
- Stock of a controlled foreign corporation (section 1248).
- Section 1245 property.
- Section 1245 recovery property.
- Section 1250 property.
- Market discount bonds (section 1278).
- Short-term governmental obligations (section 1283).
- Other short-term obligations (section 1283(c)).

Inventory items. Inventory items are not just stock in trade of the partnership. They also include the following.

- Any properties that would be included in inventory if on hand at the end of the tax year or that are held primarily for sale to customers in the normal course of business.
- Any asset that is not a capital asset or is not treated as a capital asset.
- Any other property held by the partnership that would be considered inventory if held by the transferor partner.
- Any trade receivables of accrual method partnerships.

Tiered partnerships. In determining whether partnership property is an unrealized receivable or an inventory item, the partnership is treated as owning its proportionate share of the property of any other partnership in which it is a partner. See section 751(f).

Penalty for late filing of correct Form 8308. A penalty may be imposed for failing to file each Form 8308 when due, including extensions. The penalty may also be imposed for failing to include all required information on Form 8308 or for furnishing incorrect information. The penalty is based on when the partnership files a correct Form 8308.

The penalty will not apply to any failure that the partnership can show was due to reasonable cause and not willful neglect.

For more details, see sections 6721 and 6724.

Penalty for failure to furnish correct Forms 8308 to transferor and transferee. A penalty may be imposed for each failure to furnish when due a copy of Form 8308 to either party to the exchange. The penalty may also be imposed for each failure to give the transferor or transferee all required information on each Form 8308 or for furnishing incorrect information. If the partnership intentionally disregards the requirement to report correct information, each penalty is increased. The penalty will not apply to any failure that the partnership can show was due to reasonable cause and not willful neglect. See sections 6722 and 6724 for more details.

Partnership address. Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the partnership has a P.O. box, show the box number instead.

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for business taxpayers filing this form is approved under OMB control number 1545-0123 and is included in the estimates shown in the instructions for their business income tax return.

If you have suggestions for making these forms simpler, we would be happy to hear from you. You can send us comments from *www.irs.gov/FormComments*. You can write to the Internal Revenue Service, Tax Forms and Publications, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. Do not send Form 8308 to this address. Instead, see *When to file* on page 1.

GIFT OF A PARTNERSHIP INTEREST

A gift of property, including a partnership interest, is generally not a transaction subject to income taxation. The donor typically has no income tax consequences, and the donee takes a carryover basis in the partnership interest.

Partnership Interest with Liabilities Allocated

An important exception to this rule exists where the liabilities to which the transferred property is subject exceed the donor's basis in his partnership interest. Such a transfer is treated as part gift and part sale (Reg. Section 1.1001-1(e)).

The amount of the sale is determined first. Sale proceeds equal total debt assumed by the donee. The donor's basis in the sale portion of the transaction is his total basis in the partnership interest. This permits only the excess of liabilities over basis to be taxable. Resulting gain is taxable as ordinary income to the extent required under IRC Section 751. In no event can a loss be recognized on the transfer.

The net gift to the donee is the total value of the partnership interest less the amount realized (the transferor's share of partnership liabilities). Thus, partners with a negative tax basis capital account who have used liabilities to create basis in the partnership will end up with taxable income despite the fact that the transaction is a "gift."

Assignment of Income Issues

It is possible the Service could attack a gift where the partnership has unrealized receivables even though liabilities do not exceed basis. Using the assignment of income doctrine, the Service could assert that such a transfer could not cause the unrealized receivables to be taxed to the donee but must be taxed to the donor at the date of transfer. The Service has asserted that a taxable transaction resulted from a gift of a partnership interest where the partnership held installment sale notes receivables (Rev. Rul. 60-352).

Partnership Interests Transferred by Gift—Tax Issues

Transfers of partnership interests by gift usually involve donors and donees who are members of the same family. The result is often a family partnership. While many readers may immediately start thinking transfer tax issues, today's course isn't looking at those issues (which represent a whole full-day course in and of itself).

Rather, many advisers may, in their rush to deal with transfer tax issues, overlook that the original "family partnership" rules (now renamed to "partnership interests created by gift" in the law) related to perceived income tax abuses. These rules, found in IRC Section 704(e), attempt to limit income shifting among family members from service providers to inactive family members (such as children).

If the income earned by a partnership is primarily attributable to the individual efforts and talents of its partners, any allocation of that income to nonproductive partners would be an unwarranted assignment of earned income. Thus, a family member cannot be a partner in a personal or professional service business unless she is capable of performing the type of services offered to the partnership's clientele.

A family member can be a partner in a business in which capital is a material income producing factor. Section 704(e)(2) provides that in the case of a capital interest in a partnership created by gift, the income allocable to such interest cannot be proportionately greater than the income allocated to the donor's capital.

Section 704(e)(2) also requires that any allocation of income with respect to donor and donee partners take into account the value of services rendered to the partnership by the donor. This prevents a donor partner from forgoing reasonable compensation from the partnership in order to maximize the amount of income shifted to the donee partners.

The Bipartisan Budget Act of 2015 made some changes to these rules to clarify that merely not running afoul of these provisions did, by itself, mandate a finding that an interest holder had to be respected as a partner for federal tax purposes. In addition to renaming the section as noted earlier, it added the following to the end of IRC Section 761(b):

> In the case of a capital interest in a partnership in which capital is a material income producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.

Charitable Contributions

A contribution of a partnership interest to a charitable organization is very similar to any other gift. Generally, the amount of the gift is the FMV of the property transferred less the liabilities assumed. If the liabilities assumed exceed the donor's basis, the transaction again becomes part gift and part sale.

The amount of sale proceeds is the total amount of debt assumed, but the basis must be allocated between the sale and the gift based on the relative FMVs of the gift and the sale elements (IRC Section 1011(b)). This differs from other gifts where all basis was allocated to the sale element.

A gift to a charitable organization is demonstrated in the following example.

EXAMPLE

Charitable Contribution

Toni makes a charitable contribution of her interest in the Quick Partnership. At the date of contribution, her interest has the following characteristics:

Fair Market Value	$30,000
Liabilities	$20,000
Basis	$15,000

Toni's transfer is part sale and part contribution, calculated as follows:

	Sale	Charitable Contribution
Fair Market Value	$20,000	$10,000
Basis	$10,000	$5,000
Gain Recognized	$10,000	

The character of the gain recognized on the sale is determined under IRC Section 741 (and IRC Section 751(a) to the extent it applies). Although Toni does not recognize any gain on the contribution portion, she

is required to reduce her charitable contribution deduction for any amounts that would have been recognized as ordinary income if the interest had been sold (IRC Section 170(e)).

Note that the substantiation rules of IRC Section 170 often require an appraisal in the event of a gift of a partnership interest. Since the standard of value for contributions is FMV, the appraised value should take into consideration any marketability, minority, and other similar discounts.

However, a qualified appraisal must be obtained for charitable contributions in excess of $5,000. The Pension Protection Act of 2006 added new requirements for charitable contribution appraisals.

Notice 2006-96 provides guidance on what requirements an appraisal must meet in order to be a qualified appraisal for tax purposes.

ABANDONMENT OR FORFEITURE

In some instances, a partner may attempt to simply walk away from his partnership interest. In some cases, he may be required to forfeit his interest without compensation under the partnership agreement. Abandonment or forfeiture of a partnership is typically a taxable event.

However, it's not easy to avoid a sale of an interest when the taxpayer simply walks away from the interest due to the deemed cash distribution rules under Section 752(b) when the partnership has any liabilities.

If the partnership has any liabilities, gain or loss is typically recognized under the following chronology:

- The reduction in liabilities is treated as a cash distribution to the partner (IRC Section 752(b)).
- Gain or loss recognized from a cash distribution is treated as gain or loss from the sale or exchange of the partnership interest (IRC Section 731(a)).
- Gain or loss from a sale or exchange is capital in nature except as provided in IRC Section 751 (IRC Section 741).

Rev. Rul. 93-80 holds that the loss from the abandonment or worthlessness of a partnership will be ordinary if there is neither an actual nor a deemed distribution to the partner. Any decrease in a partner's share of partnership liabilities is deemed to be a distribution of money to the partner under Section 752(b). Even a de minimis actual or deemed distribution makes the entire loss a capital loss.

Additionally, the loss under Rev. Rul. 93-80's analysis would be ordinary only if the transaction is not otherwise in substance a sale or exchange. For example, a partner's receipt of consideration from another partner may, depending upon the facts and circumstances, establish that a purported abandonment or worthlessness of a partnership interest is in substance a sale or exchange (see also *Citron v. Commissioner*, 97 T.C. 200, (1991)). Tax practitioners should recall that accounts payable constitutes a liability, even for a cash-basis partnership.

EXAMPLE

Capital Loss on Abandonment

Luther is a 25% partner in Glamour Partnership. The partnership hasn't been doing well, and Luther wants to get out of the partnership. In 2016, Luther abandons his interest, signing it over to the partnership.

On the date Luther abandons his interest, his basis is:

Tax Basis Capital Account	$25,000
Share of Glamour's Liabilities	$40,000
Luther's Basis	$65,000

The assumption of liabilities by the partnership on the abandonment is treated as a distribution of cash. Thus, Luther's basis for gain or loss on the abandonment equals $20,000, his tax basis capital account. Since the partnership has liabilities, the transaction is treated as a sale or exchange. Accordingly, Luther has a $25,000 capital loss deductible in 2016, assuming Luther has other capital gains to offset the loss against.

One problem with a partnership abandonment is that the partner must establish the date the abandonment occurred. That is frequently harder than it might seem. There is no provision in the Internal Revenue Code for abandoning a partnership interest. However, there must be some manifestation of an intent to abandon by one or more acts calculated to give third parties notice of the abandonment. Of course, the more actions and statements a partner makes, the more evident the abandonment will be (Echols v. Commissioner, 935 F.2d 703 (CA5, 1991)).

One issue that is clear is that Rev. Rul. 93-80 provides that an ordinary loss is not a possibility if there is any reduction debt allocated to the partner—something that made ordinary loss abandonment exceedingly difficult even before the Tax Court pointed out a second difficulty.

Unit

8

Partners' Basis Adjustments (Sections 734, 743 & 754) & at Risk

LEARNING OBJECTIVES

- **Identify** those situations resulting in an opportunity to adjust a partner's basis to match that partner's basis in the underlying partnership assets.
- **Understand** the at-risk rules for computing partnership basis.
- **Calculate** and **allocate** the partnership basis adjustment among the assets.
- **Understand** how future basis adjustments are allocated.

INTRODUCTION

Prior to joining a partnership, an incoming partner owns assets in which he has tax basis for purposes of determining gain or loss on sale. The partnership assumes that basis when those assets are contributed to the partnership. The partnership's holding period is determined as if the partnership had owned the property as long as the contributing partner owned it. The partnership determines and allocates gains, losses, deductions, and credits relating to the property and, except as may be required by IRC Section 704(c), the property loses its identity with the partner who previously owned it.

The partner now owns a fractional interest or units of interest in the partnership. This interest may generally be sold, exchanged, gifted, left by bequest, or otherwise disposed of without in any way affecting the partnership or its ownership of individual assets. The basis of this property, now owned by the partnership, becomes significant in several situations.

- When a partner sells or exchanges his interest in the partnership, gain or loss is recognized and must be calculated by reference to the basis of the partnership interest.
- When a partner gifts his interest in the partnership, the donee takes a basis determined by reference to the donor's basis in the partnership interest.
- Losses allocated to a partner are not deductible to the extent they exceed the partner's basis in his partnership interest (this is dealt with in greater detail later in this module).

- The tax treatment of partnership distributions (basis of property distributed and gain or loss recognized on distribution) is determined in large part by the partner's basis in the partnership interest.

"INSIDE" VS. "OUTSIDE" BASIS

The terminology "inside basis" and "outside basis" is frequently used in dealing with partnerships and refers to what can be one of the most complex tax problems in this area. Inside basis simply refers to the partnership's tax basis in its assets, while outside basis refers to the partners' tax bases in their partnership interests.

In a simple partnership, the inside basis and outside basis will be equal. The following examples demonstrate some ways basis differences come about.

EXAMPLE

Contribution of Property

Greg and Damon form the Grego Partnership with the following contributions:

	Fair Market Value	Basis
Greg—Cash	$10,000	$10,000
Damon—Property	$10,000	$2,000

Total inside basis is $12,000 and total outside basis is $12,000, but neither partner's outside basis equals his proportionate share (50%) of the inside basis.

EXAMPLE

Transfer of Interest

The balance sheet of the Stayput Partnership is as follows:

	Fair Market Value	Basis
Assets	$30,000	$9,000
Capital:		
Zack	$10,000	$3,000
Molly	$10,000	$3,000
Shannon	$10,000	$3,000
Total Capital	$30,000	$9,000

Zack sells his interest to Dawn for its fair market value of $10,000. Absent an election under IRC Section 754, the inside basis remains at $9,000, but total outside basis is now $16,000 ($3,000 + $3,000 + $10,000).

EXAMPLE

Cash Distribution

The balance sheet of Hardway Partnership is as follows:

	Fair Market Value	Basis
Assets	$30,000	$9,000
Liabilities	$18,000	$18,000
Capital:		
Karl	$4,000	–$3,000
Ed	$4,000	–$3,000
Ellen	$4,000	–$3,000
Total Capital	$12,000	–$9,000
Total Liabilities and Capital	$30,000	$9,000

The partnership makes a nonliquidating cash distribution of $3,500 to Karl. Before the distribution, his basis is $3,000 (1/3 of the liabilities of $18,000 less his capital account of ($3,000)). Because Karl's basis cannot become negative, he recognizes $500 taxable income from the distribution and has a zero basis in his partnership interest. Total inside basis (absent an IRC Section 754 election) is now $5,500 while total outside basis is $6,000 ($3,000 + $3,000 + $0).

BASIS ELECTIONS

An election by the partnership under the provisions of IRC 754 allows the basis of partnership's assets to be adjusted to reflect the results of certain transactions. IRC Section 754 is the election section. An IRC Section 754 election permits adjustments under IRC 743 and 734. There is one exception, however, where an adjustment is required even if no election is in place.

IRC Section 743: Transfer of an Interest

Since a purchaser will generally pay fair market value (FMV) for an interest in a partnership, without an adjustment there would be recognition of the same income twice. This results from the carryover of inside basis. Thus, the partner will have an outside basis equal to the purchase price and an inside basis equal to the partner's proportionate share of the partnership's basis. The adjustments under IRC 743 increase or decrease the inside basis to FMV, thus equalizing inside and outside basis. This adjustment is solely for the transferee partner.

The partner's adjusted basis in the partnership property is equal to the sum of:

- the partner's interest in the previously taxed capital of the partnership and
- his share of the partnership liabilities.

The transferee's interest in the previously taxed capital is:

- the amount of cash that the transferee would receive on a hypothetical liquidation, plus
- the amount of any tax loss that would be allocated from the hypothetical liquidation, less

- the amount of tax gain that would be allocated to the partner on the hypothetical liquidation (Reg. Sections 1.742-1 and 1.743-1).

EXAMPLE

Calculation of Basis Adjustment

Liz purchases a one-third interest in the capital and profits of Hightest Partnership from Norm for $26,000 in cash. The partnership has an IRC Section 754 election in effect.

At the time of purchase, the partnership balance sheet is as follows:

	Basis	Fair Market Value
Assets		
Cash	$5,000	$5,000
Accounts Receivable	$10,000	$10,000
Inventory	$20,000	$27,000
Depreciable Assets	$20,000	$46,000
Total	$55,000	$88,000
Liabilities and Capital		
Liabilities	$10,000	$10,000
Joe's Capital	$15,000	$26,000
Brian's Capital	$15,000	$26,000
Norm's Capital	$15,000	$26,000
Total	$55,000	$88,000

Liz's adjustment is determined as follows:

Outside Basis:	
Cash Paid	$26,000
Share of Liabilities Assumed	$3,333
Outside Basis	$29,333
Less: Adjusted Basis in Property	
Cash from Hypothetical Liquidation	$26,000
Liz's Share of Tax Gain	–$11,000
Liz's Share of Liabilities	$3,333
Adjusted Basis in Property	$18,333
Adjustment	$11,000

Once the amount of the adjustment has been determined, it must be allocated to the various assets for the benefit of the incoming partner. In making the allocation, the partnership assets are divided into two groups:

- Ordinary income property.
- Capital and IRC Section 1231 property.

The allocation to the classes is based on a hypothetical transaction in which all of the assets of the partnership are disposed of in a fully taxable transaction. The basis step-up is allocated to the classes.

- First, basis is allocated to ordinary income assets based on the amount of income, gain, or loss that would be allocated from the hypothetical sale, taking into consideration the allocation methods being used (i.e., curative method, Reg. Section 1.743-3(d)).
- Anything remaining is allocated to capital and IRC Section 1231 assets. However, in no event can a decrease be allocated in excess of basis. Any excess is used to reduce the basis of ordinary income property.

Once allocated to a class, the adjustment must be allocated within the class. This is done on the same hypothetical sale scenario. It should be noted that there might be a positive allocation to one class and a negative to another even with a net zero adjustment (see Reg. Section 1.755-1(b)).

EXAMPLE

Allocation of Basis Adjustment

Tammi purchases a one-third interest in Goaway Partnership for $19,000. Her ratable share of the partnership's assets is as follows:

	Fair Market Value	Old Basis	Difference	New Basis
Capital Gain/1231:				
Land	$6,000	$2,000	$4,000	$6,000
Stock	$3,000	$5,000	–$2,000	$3,000
Total	$9,000	$7,000	$2,000	$9,000
Other Assets:				
Inventory	$5,000	$3,500	$1,200	$5,000
Unreal. Rec.	$5,000	$2,500	$2,500	$5,000
Total	$10,000	$6,000	$4,000	$10,000
Total Assets	$19,000	$13,000	$6,000	$19,000

The optional adjustment is $6,000. Under the hypothetical sale, Tammi would be allocated

$4,000 of ordinary income items. Therefore, $4,000 will be allocated to the ordinary income class and the balance to capital gain/Section 1231 gain.

Within the classes, the adjustment to assets inventory and unrealized receivables is equal to the gain that would be allocated to such assets or $1,500 and $2,500, respectively. Within the Capital gain/1231 category, the basis of land is increased to $6,000 and stock basis is reduced to $3,000 (a net adjustment of a positive $2,000).

Land	$6,000
Stock	$3,000
Inventory	$5,000
Unrealized Receivables	$5,000
Total	$19,000

If a positive adjustment is made to depreciable assets, the adjustment amount creates a new asset depreciable on the same basis as the underlying asset. If a negative adjustment is made to depreciable assets, it creates reportable income. This is one of the downsides to the election.

A subsequent transfer of positively adjusted property to another partner requires the adjustment to be reallocated to similar partnership property. If none, then the adjustment is held until similar property is obtained and attached to it. If property is sold, the adjustment reduces the gain for the partner.

EXAMPLE

Distribution of Adjusted Property

Growfast Partnership makes a current distribution of land to each of its three partners. Helen had purchased her interest from Pete while an election under IRC Section 754 was in effect.

The basis of the property and the adjustment is as follows:

Property	Basis	Adjustment
Asset 1	$20,000	$2,000
Asset 2	$24,000	$3,000
Asset 3	$22,000	$5,000

Helen has an interest basis of $50,000 at the time of the distribution. Helen receives Asset 3. Helen's basis in Asset 3 after the distribution is $32,000 (carryover basis plus the IRC Section 743 adjustment for herself and the adjustment on Assets 1 and 2). Her basis in the partnership interest is now $18,000 ($50,000 minus $32,000).

IRC Section 734 Adjustment: Distributions

The adjustment under IRC Section 734 applies when property is distributed to a partner and gain is recognized. The adjustment is necessary to prevent a double recognition of gain. The problem can be seen in the following example.

EXAMPLE

Liquidating Distribution Creates Basis Adjustment

Lisa receives $9,000 cash as a liquidating distribution for her one-third interest in the Rebound Partnership. Lisa's basis in the partnership at the time of the distribution is $6,000.

The partnership's balance sheet immediately before the distribution is as follows:

	Basis	Fair Market Value
Asset:		
Cash	$9,000	$9,000
Land	$9,000	$18,000
Total	$18,000	$27,000
Partner's Capital:		
Al	$6,000	$9,000
Lisa	$6,000	$9,000
Fred	$6,000	$9,000
Total	$18,000	$27,000

The partnership has $9,000 of unrealized gain before the distribution. All of this gain is attributable to the land. Because Lisa receives cash in excess of basis, she will report a $3,000 ($9,000 – $6,000) gain.

If no IRC Section 754 election is in effect, the basis of the land to the partners will remain at $9,000. Thus, if the land is sold the next day, the remaining partners will have to report a gain of $9,000 ($4,500 each). In effect, Lisa's portion of the predistribution gain has been shifted to the other partners and recognized twice.

The IRC Section 734 adjustment would allow the partnership to increase the basis in the land for the gain recognized by Lisa. Thus, the basis would be increased to $12,000. Upon sale, the gain would be $6,000 rather than $9,000.

The adjustment may be either positive or negative. The adjustment depends on the type of distribution. There are three possible scenarios:

- Cash is distributed in excess of the partner's basis and gain is recognized. The positive adjustment will be equal to the gain recognized as shown in the previous example.
- Cash, unrealized receivables, and inventory are distributed and the partner recognizes a loss. The negative adjustment is equal to the loss recognized by the partner.
- Property is distributed to the partner whose interest basis is less than the partnership's basis in the distributed property. The positive adjustment is equal to the difference between the partnership's basis in the property and the partner's interest basis.

EXAMPLE

Increase in Partnership Basis

Mike receives a distribution of land from Bigdirt Partnership. The land has a basis to Bigdirt of $15,000 while Mike's interest basis in the partnership is only $10,000. Mike's basis in the property is limited to $10,000 and his interest basis is reduced to zero. The partnership will increase the basis of its other assets by $5,000, the lost basis in the property.

A partner receives a liquidating distribution of property when his partnership interest basis exceeds the partnership's basis in the property distributed. The negative adjustment is equal to the difference in basis

Once the amount of the adjustment has been determined, the property is divided into the two classes of property as in the IRC Section 743: ordinary income and capital gain/ Section 1231 gain.

The adjustment is allocated between the classes as follows.

- If an adjustment is based upon a gain or loss determined by the difference between the FMV and adjusted basis of the distributed property, then the allocation is made to the same property class.
- If an adjustment is based upon a gain or loss recognized by the distributee partner under IRC Section 731 (b)(1)(A) or (b)(2)(A), then the adjustment is made only to the capital/1231 class on a similar approach as IRC Section 743.

In no event can the basis be reduced below zero. Any such adjustment is suspended until the partnership has property of a similar nature.

IRC Section 754 & Tiered Partnerships

One issue that xx must be addressed is the treatment of an IRC Section 754 election in a tiered partnership arrangement when an interest in the upper tier partnership is transferred. The treatment depends on which partnership has the election in effect.

- *Both have the election.* Make the adjustment for the assets of both.
- *Upper tier has election but lower tier does not.* Adjust only the upper-tier assets.
- *Lower tier has the election but upper tier does not.* No adjustment is made.

In essence, you keep going down the ownership chain until you hit the first partnership that does not have and does not make the election. From that point on, no adjustments are made, regardless of the status of any lower-tier partnerships.

Section 168(k) Additional First-Year Depreciation & Basis Adjustments

The opening up of the additional first year depreciation to used assets by the passage of the Tax Cuts and Jobs Act added the questions of whether, and under what circumstance, an adjustment under IRC Sections 734 or 743 would qualify for additional first year depreciation. The IRS came up with a nuanced answer in the proposed regulations under Section 168(k).

We will discuss the progress through the proposed regulation process but note that in the end, basis adjustments under Section 734 do not qualify under the regulations whereas they may qualify under Section 743 (T.D. 9874, September 2019, amendments as to qualifying property under Section 743, see Regs. 1.743-1(j)(4)(i)(B)(1), (2), (l)).

Section 734(b) Adjustments

The Sections 734 and 743 adjustments take place when a partnership either has a Section 754 election in place made in a prior year or makes such an election in the affected year. In both cases an adjustment is computed to take into account some differences between "inside" and "outside" basis upon the occurrence of certain transactions.

The IRS explains a Section 734(b) adjustment as follows in the preamble:

> Section 734(b)(1) provides that, in the case of a distribution of property to a partner with respect to which a Section 754 election is in effect (or when there is a substantial basis reduction under Section 734(d)), the partnership will increase the adjusted basis of partnership property by the sum of (A) the amount of any gain recognized to the distributee partner under Section 731(a)(1), and (B) in the case of distributed property to which Section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by Section 732(d)) over the basis of the distributed property to the distributee, as determined under Section 732.

The IRS concludes that a Section 734(b) adjustment fails to qualify for bonus depreciation because the property in question that is receiving the adjustment is property previously owned by the partnership.[110] The preamble explains:

[110] Proposed Reg. Section 1.168(k)-2(b)(3)(iv)(C)

> Because a Section 734(b) basis adjustment is made to the basis of partnership property (i.e., non-partner specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment, a Section 734(b) basis adjustment fails the original use clause in Section 168(k)(2)(A)(ii) and also fails the used property requirement in Section 168(k)(2)(E)(ii)(I). The proposed regulations therefore provide that Section 734(b) basis adjustments are not eligible for the additional first year depreciation deduction.

Section 743(b) Adjustments

Given that the IRS decided that the bonus depreciation options do not apply to Section 704(c) allocations, reverse Section 704(c) allocations, property distributed to a partner and to Section 734(b) adjustments, you might assume the same answer would apply to Section 743(b) adjustments. But such a conclusion would be in error—in this case the IRS allows the use of bonus depreciation for the Section 743(b) adjustment.

A Section 743(b) adjustment is what comes to mind most often when CPAs are thinking about a Section 754 election. The IRS explains the situations where a Section 743(b) adjustment is appropriate in the preamble:

> Section 743(b)(1) provides that, in the case of a transfer of a partnership interest, either by sale or exchange or as a result of the death of a partner, a partnership that has a Section 754 election in effect (or if there is a substantial built-in loss immediately after such partnership interest transfer under Section 743(d)), will increase the adjusted basis of partnership property by the excess of the transferee's basis in the transferred partnership interest over the transferee's share of the adjusted basis of partnership's property. This increase is an adjustment to the basis of partnership property with respect to the transferee partner only and, therefore, is a partner specific basis adjustment to partnership property. The Section 743(b) basis adjustment is allocated among partnership properties under Section 755.

But the IRS concludes that, because this being allocated to only a new partner, the taxpayer in question does not have a disqualifying prior ownership interest.[111]

> As stated above, prior to the Act, a Section 743(b) basis adjustment would always fail the original use requirement in Section 168(k)(2)(A)(ii) because partnership property to which a Section 743(b) basis adjustment relates would have been previously used by the partnership and its partners prior to the transfer that gave rise to the Section 743(b) adjustment. After the Act, while a Section 743(b) basis adjustment still fails the original use clause in Section 168(k)(2)(A)(ii), a transaction giving rise to a Section 743(b) basis adjustment may satisfy the used property clause in Section 168(k)(2)(A)(ii) because of the used property acquisition requirements of Section 168(k)(2)(E)(ii), depending on the facts and circumstances.
>
> Because a Section 743(b) basis adjustment is a partner specific basis adjustment to partnership property, the proposed regulations take an aggregate view and provide that, in determining whether a Section 743(b) basis adjustment meets the used property acquisition requirements of Section 168(k)(2)(E)(ii), each partner is treated as having owned and used the partner's proportionate share of partnership property. In the case of a transfer of a partnership interest, Section 168(k)(2)(E)(ii)(I) will be

[111] Proposed Reg. Section 1.168(k)-2(b)(3)(iv)(D)(1)

> satisfied if the partner acquiring the interest, or a predecessor of such partner, has not used the portion of the partnership property to which the Section 743(b) basis adjustment relates at any time prior to the acquisition (that is, the transferee has not used the transferor's portion of partnership property prior to the acquisition), notwithstanding the fact that the partnership itself has previously used the property. Similarly, for purposes of applying Section 179(d)(2)(A), (B), and (C), the partner acquiring a partnership interest is treated as acquiring a portion of partnership property, and the partner who is transferring a partnership interest is treated as the person from whom the property is acquired.

The preamble continues to note that some rules could still bar the use of bonus depreciation.[112]

The preamble notes:

> For example, the relationship between the transferor partner and the transferee partner must not be a prohibited relationship under Section 179(d)(2)(A). Also, the transferor partner and transferee partner may not be part of the same controlled group under Section 179(d)(2)(B). Finally, the transferee partner's basis in the transferred partnership interest may not be determined in whole or in part by reference to the transferor's adjusted basis, or under Section 1014

Since inherited property has basis determined under IRC Section 1014, there is no option to claim the additional first year depreciation under Section 168(k) on a Section 743(b) adjustment arising from the death of a partner—even if the interest passes to an unrelated third party.

The preamble also notes that the issue of whether the acquiring party is or is not currently a partner in the partnership doesn't matter.

> The same result will apply regardless of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another partner. Assuming that the transferor partner's specific interest in partnership property that is acquired by the transferee partner has not previously been used by the transferee partner or a predecessor, the corresponding Section 743(b) basis adjustment will be eligible for the additional first year depreciation deduction in the hands of the transferee partner, provided all other requirements of Section 168(k) are satisfied (and assuming Section 1.743-1(j)(4)(i)(B)(2) does not apply). This treatment is appropriate notwithstanding the fact that the transferee partner may have an existing interest in the underlying partnership property, because the transferee's existing interest in the underlying partnership property is distinct from the interest being transferred.

The IRS also rules that an election out of bonus depreciation for classes of property can be made independently by the partnership for Section 743(b) adjustment "property" created during the year and the assets the partnership placed in service generally during the year.[113]

> Finally, the proposed regulations provide that a Section 743(b) basis adjustment in a class of property (not including the property class for Section 743(b) basis adjustments) may be recovered using the additional first year depreciation deduction under Section 168(k) without regard to whether the partnership elects out of the

[112] Proposed Reg. Section 1.168(k)-2(b)(3)(iv)(D)(2)

[113] Proposed Reg. Section 1.743-1(j)(4)(i)(B)(1)

> additional first year depreciation deduction under Section 168(k)(7) for all other qualified property in the same class of property and placed in service in the same taxable year. Similarly, a partnership may make the election out of the additional first year depreciation deduction under Section 168(k)(7) for a Section 743(b) basis adjustment in a class of property (not including the property class for Section 743(b) basis adjustments), and this election will not bind the partnership to such election for all other qualified property of the partnership in the same class of property and placed in service in the same taxable year.

The IRS gives a series of examples to show how to test to see if a Section 743(b) transaction qualifies for the additional first year depreciation under IRC Section 168(k).

EXAMPLE 14

Reg. § 1.168(k)-2(b)(3)(vii)(N)

Q, R, and S form an equal partnership, QRS, in 2019. Each partner contributes $100, which QRS uses to purchase a retail motor fuels outlet for $300. Assume this retail motor fuels outlet is QRS' only property and is qualified property under Section 168(k)(2)(A)(i). QRS makes an election not to deduct the additional first year depreciation for all qualified property placed in service during 2019. QRS has a Section 754 election in effect. QRS claimed depreciation of $15 for the retail motor fuels outlet for 2019. During 2020, when the retail motor fuels outlet's fair market value is $600, Q sells all of his partnership interest to T in a fully taxable transaction for $200. T never previously had a depreciable interest in the retail motor fuels outlet. T takes an outside basis of $200 in the partnership interest previously owned by Q. T's share of the partnership's previously taxed capital is $95. Accordingly, T's Section 743(b) adjustment is $105 and is allocated entirely to the retail motor fuels outlet under Section 755. Assuming all other requirements are met, T's Section 743(b) adjustment qualifies for the additional first year depreciation deduction.

EXAMPLE 15

Reg. § 1.168(k)-2(b)(3)(vii)(N)

The facts are the same as in Example 14 of paragraph (b)(3)(vi)(N) of this section, except that Q sells his partnership interest to U, a related person within the meaning of Section 179(d)(2)(A) or (B) and Section 1.179-4(c). U's Section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

EXAMPLE 16

Reg. § 1.168(k)-2(b)(3)(vii)(N)

The facts are the same as in Example 14 of paragraph (b)(3)(vi)(N) of this section, except that Q dies and his partnership interest is transferred to V. V takes a basis in Q's partnership interest under Section 1014. As a result, Section 179(d)(2)(C)(ii) and Section 1.179-4(c)(1)(iv) are not satisfied, and V's Section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

EXAMPLE 17

Reg. § 1.168(k)-2(b)(3)(vii)(N)

The facts are the same as in Example 14 of paragraph (b)(3)(vii)(N), except that QRS purchased the retail motor fuels outlet from T prior to T purchasing Q's partnership interest in QRS. T had a depreciable interest in such retail motor fuels outlet. Because T had a depreciable interest in the

retail motor fuels outlet before T acquired its interest in QRS, T's Section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

Making the Election (Reg. Section 1.754-1(b))

The election is made with the filing of the return for the year the transfer or distribution took place. The election must include the name and address of the partnership and a statement that the partnership elects to have the provisions of IRC Section 743 and 734 apply. The election no longer must be signed by a partner. [Proposed Reg. Section 1.754-1(b), "taxpayers may rely"] See generally Ed Zollars, "Signature No Longer Required When Making IRC Section 754 Elections," Current Federal Tax Developments, Kaplan Financial Education, October 13, 2017. An electing partnership must apply both IRC Section 734 and IRC Section 743. It cannot elect only one of the provisions.

Required Attachments

In any year a distribution is made that requires an adjustment, the partnership must attach a statement to the return showing the computation of the adjustment and the allocation to partnership assets. If a transfer of an interest takes place, the transferee partner must file a statement with his return showing the same information.

Late Election Relief

As with any tax election, a failure to make the election deprives the partner or partners of potential tax advantages. Unfortunately, many partnerships fail to file timely elections and have sought relief from the IRS. Recognizing the importance of the IRC Section 754 election and the resources that could be wasted addressing each failure to timely make the election, Reg. Section 301.9100-2 provides an automatic 12-month extension to make the election.

Reg. Section 301.9100-2(d) provides that the late election is made by filing the required statement with an amended partnership tax return within 12 months of the date of the original deadline. The election must have the following statement at the top of the filing: FILED PURSUANT TO Section 301.9100-2. Of course, any affected partner must file his return in accordance with the amended return.

If the partnership fails to meet the late-filing deadline (i.e., it isn't aware that a transfer has taken place—such as an unreported partner death, etc.), then the partnership can ask the IRS for a waiver of the deadline in a private letter ruling under Reg. Section 301.91003. Such a waiver is not granted automatically, but the IRS does regularly issue such rulings (after, of course, collecting the requisite user fee).

Revocation of Election

Once made, the election is effective for all transfers and distributions until revoked. It can only be revoked with permission of the Service. The Service will not grant permission solely to avoid a downward adjustment. Generally, the following are considered to be valid reasons:

- A change in the nature of the partnership business
- A substantial increase in the partnership assets

- A change in the type of partnership assets
- An administrative burden caused by frequent adjustments

An election revocation request must be filed with the district director within 30 days of the close of the tax year in which the revocation is to be effective. It must state the grounds for the request.

IRC Section 732(d) Election

Partners are not always willing to make an IRC Section 754 election because of the potential negative effects. IRC Section 732(d) may provide limited relief for a partner who acquires an interest when no IRC Section 754 election is in effect. In a limited set of circumstances, the IRC Section 732(d) election allows a partner to treat distributed property as if the IRC Section 754 election had been in effect.

To be eligible for this election:

- the partner must have acquired his interest by sale, exchange, or upon death of a partner while no IRC Section 754 election was in effect, or
- a distribution of appreciated property must be made to the partner within two years of the interest transfer.

The partner is allowed to treat the distributed property as if an IRC Section 743 adjustment had been made before the property is distributed. Thus, the normal basis rules under IRC Section 732 will be applied without modification. Basis will be determined without adjustment for hypothetical depreciation, amortization, or depletion on the modified amount. Only the actual depreciation, amortization, or depletion is considered in adjusting basis.

EXAMPLE

IRC Section 732 Election

On July 1, 2017, Lou purchases a 25% interest in ABC partnership for $40,000. No IRC Section 754 election is in effect at the time.

Lou's inside and outside basis is as follows:

	Inside	Outside
Cash	$8,000	$8,000
Inventory	$12,000	$24,000
Land	$6,000	$8,000
Total	$26,000	$40,000

On July 1, 2018, Lou receives a current distribution from the partnership. Assume that by application of IRC Section 751(b) there will be a deemed sale of inventory by Lou to the partnership for $6,000 cash. The basis in that inventory is $3,000. Thus, Lou has $3,000 of ordinary income.

If Lou makes an IRC Section 732(d) election, the basis in the inventory will increase to twice the amount. The inventory's basis becomes $6,000 and no income is recognized.

Making the Section 732(d) Election

To elect IRC Section 732(d), the partner attaches an election to his return making the election and showing the basis adjustments and allocations. If the property is not subject to depreciation, amortization, or depletion then the election need not be made until the year in which the distributee determines the income tax consequence for the property distributed, (e.g., upon sale).

Mandatory Section 732 Adjustment

The adjustment under IRC Section 732 is mandatory if:

- at the time of the transfer, the FMV of the partnership assets, except cash, exceeded 110% of inside basis;
- the liquidation of the partner's interest and application of the basic rules of IRC Section 732(c) would result in shifting basis to property subject to depreciation, amortization, or depletion; or
- the property distributed to the partner would have had a basis adjustment had an IRC Section 754 election been in effect.

Substantial Built-in Loss & Mandatory Adjustments

Congress became aware that tax shelters were abusing IRC Section 754 by failing to make an IRC Section 754 election, thereby enabling the partnership to shift partnership losses to incoming or outgoing partners. Accordingly, Congress now requires partnerships with substantial built-in losses to make an adjustment as though a Section 754 election is in effect, whether or not the partnership actually makes the election.

Since partnerships that have made an IRC Section 754 election aren't able to shift losses, the new rule applies only to those partnerships with no IRC Section 754 election in place.

Partnerships required to make the adjustment must make it when there is a distribution to partners or where there is a sale or other disposition of a partnership interest, including a disposition by death.

Substantial Built-in Loss Test

The good news is that the adjustment must be made only when there would be a reduction in the basis of the partnership assets of more than $250,000 if an IRC Section 754 election was in effect. However, this test is applied at the partnership, rather than partner,level.

There is no small-transfer exception to these rules. Thus, even a de minimis transfer of a partnership interest will trigger the mandatory adjustment if the $250,000 threshold is met. This may inflict considerable complexity on small partnerships that deliberately have avoided making the IRC Section 754 election because of its complexity.

The Tax Cuts and Jobs Act added another situation where the adjustment must be made, even without an election in place. If an immediate sale would result in a $250,000 loss being allocated to the partner, then the Section 743 adjustment must be calculated even if, overall, the partnership's excess of basis over fair value of its property is less than $250,000.

Electing Investment Partnerships

The electing investment partnership (EIP) rules provide an exception to the required adjustment for partnerships that both qualify for status and make the election.

- If the partnership's only business is issuing fixed principal securities serviced by pooled receivables or similar financial assets (a securitization partnership), it is exempt.
- If a partnership can meet all of the following requirements, it is deemed eligible to be an EIP and is exempt.
  - The partnership meets the investment company definition, except it has not and won't be engaged in a public offering.
  - The partnership holds substantially all of its assets for investment and doesn't engage in any trade or business.
  - Cash must be at least 95% of the contributions to the partnership and no other contributions can have an adjusted basis in excess of FMV at the time they are contributed.
  - All interests are purchased within two years of the initial contribution.
  - The partnership will terminate within 15 years. However, if the partnership existed on June 4, 2004, it can have a term of 20 years.

The election to be an EIP is made by attaching a written statement to an original or amended return for the taxable year for which the election will be effective. The election must include the partnership's name, address, and EIN; a representation that the partnership is eligible to make the election; and a declaration that the partnership elects to be treated as an EIP. The election must be filed no later than six months after the due date of the tax return, excluding extensions.

Notice 2005-32 provides guidance on how to make the election. Once made, the election can be revoked only with the consent of the IRS. The election is made by attaching a written statement to an original or amended return for the taxable year for which the election will be effective. The statement must include the partnership's name, address, and EIN; a representation that the partnership is eligible to make the election; and a declaration that the partnership elects to be treated as an EIP.

For an EIP election to be valid, the original or amended return must be filed not later than six months after the due date (excluding extensions) for filing the partnership return for the taxable year for which the election is effective. Once an election is made, it is effective for all succeeding taxable years unless terminated or revoked.

OTHER LIMITATION RULES

At-Risk & Passive Activity Rules

Even though basis is a very important element in the deductibility of partnership losses by the partners, it is not the only hurdle that partners must clear before they can take a loss. Both the at-risk limitations and the passive loss limitations must be applied.

Both provisions were adopted by Congress decades ago in response to marketed tax shelters. Generally, the at-risk rules weren't effective at curbing the shelters, while the passive activity rules were much more effective. However, Congress has left the at-risk rules in place and they contain traps for the unwary.

At-Risk Rules

Under IRC Section 465(a), individuals and certain closely held corporations engaged in any business or income-producing activity may deduct their share of losses from the activity only to the extent of their at-risk amount in such activity. For activities conducted in the partnership form, a partner's at-risk amount corresponds very closely to the outside basis in the partnership interest.

The major difference between the two is that nonrecourse debt is included in the partner's basis under IRC Section 752(a). Any debt for which a partner is not personally liable is generally excluded from her at-risk amount. The major exception to the rule is qualified nonrecourse financing, defined as nonrecourse debt incurred in a real estate activity and borrowed from a commercial lender, such as a bank or savings and loan association.

EXAMPLE

At-Risk Rules

Craig is a limited partner and Leslie is the general partner. Each owns a 50% interest in the L&C Partnership, which purchases, develops, and manages commercial real estate. At the end of the current year, the partnership has $15,000 recourse debt, all of which is allocated to Leslie for inclusion in the basis of her partnership interest, and $100,000 of nonrecourse debt, $50,000 of which is allocated to both partners for inclusion in their basis. Only $40,000 of the nonrecourse debt is qualified nonrecourse financing. Thus, of the $65,000 total debt included in Leslie's basis, only $35,000 ($15,000 recourse debt for which she is personally liable + $20,000 qualified nonrecourse financing) is included in her at-risk amount. Of the $50,000 of debt included in Craig's partnership basis, only the $20,000 of qualified nonrecourse financing is included in his at-risk amount. A partner's at-risk amount with respect to a partnership is reduced by any partnership losses currently allowed as a deduction under IRC Section 465(a). To the extent that a partner's distributive share of current-year partnership losses exceeds her at-risk amount, such nondeductible excess may be carried forward into future years and deducted if and when the partner increases her at-risk amount above zero.

At-Risk: Qualified Nonrecourse Financing

IRC Section 465 defines at-risk as the cash and adjusted basis of property contributed to the activity plus any amount borrowed for use in the activity to the extent the taxpayer is personally liable on the debt. By definition, a partner would not be liable on nonrecourse financing except to the extent of a personal guarantee. An exception to the rule is made for qualified nonrecourse financing.

Qualified nonrecourse financing is defined in IRC Section 465(b)(6) as any nonrecourse financing (using the rules described under Section 752 described elsewhere in the manual) that:

- is borrowed for an activity of holding real property;
- is borrowed from a qualified person or borrowed from or guaranteed by any federal, state, or local government or an instrumentality;

- is not convertible debt; and
- has no person personally liable for repayment.

The debt must be secured only by real property used in the activity of holding such property; however, under a de minimis rule, personal property may be included in the security if it is incidental to providing the property and the value of such personal property does not exceed 10% of the FMV of the entire security. Appliances in an apartment building, maintenance, and office equipment used to support rental activities would be examples.

To the extent of a personal guarantee by one or more partners, the property cannot be considered qualified nonrecourse financing for the other partners. The liability can, however, be qualified on the nonguaranteed portion.

Bad Boy Provisions & Qualified Nonrecourse Debt

One key requirement to have qualified nonrecourse financing is that the financing must first be deemed nonrecourse under the Section 752 provisions that classify debt into recourse and nonrecourse. If any partner has economic risk of loss under those rules, the debt is fully allocated to that partner and none is available to allocate to other partners.

Many real estate partnerships rely on the ability of partners who have no liability on a debt to be able to use that debt basis to claim losses, with the debt being structured to meet the qualified nonrecourse rules. However, lenders are rarely willing to make such loans with no strings attached because the actions of the partnership, particularly the partner(s) with management control could negatively impact the lender's ability to either collect in full or at least limit its losses.

Thus, most loans have various provisions and caveats that are often referred to as "bad boy" provisions. In early 2016, the IRS set off a panic with a ruling (Chief Counsel Advice 201606027) that strongly suggested many, if not all, such provisions would convert the debt to recourse. The resulting concern in the real estate community eventually moved the IRS to release another piece of guidance in the form of a generic legal advice memorandum (Generic Legal Advice AM 2016-001) that effectively reversed the earlier ruling and then listed "generally acceptable" bad boy provisions.

The ruling notes that such terms are generally meant to ensure that the events in question, which are under the control of the managing members and partners, will not occur since it would bring liability for the entire unpaid debt balance down on the "bad boy" actor. That is, a rational actor subject to these provisions would ensure he never voluntarily undertook such actions.

The memorandum considered the following list of provisions that it found to be extremely unlikely to ever actually come to pass, as thus apparently would not serve to convert an otherwise Section 752 nonrecourse obligation to a recourse one.

- The borrower fails to obtain the lender's consent before obtaining subordinate financing or transfer of the secured property.
- The borrower files a voluntary bankruptcy petition.
- Any person in control of the borrower files an involuntary bankruptcy petition against the borrower.

- Any person in control of the borrower solicits other creditors of the borrower to file an involuntary bankruptcy petition against the borrower.
- The borrower consents to or otherwise acquiesces or joins in an involuntary bankruptcy or insolvency proceeding.
- Any person in control of the borrower consents to the appointment of a receiver or custodian of assets.
- The borrower makes an assignment for the benefit of creditors, or admits in writing or in any legal proceeding that it is insolvent or unable to pay its debts as they come due.

LLCs & the At-Risk Rules

A problem exists for limited liability companies (LLCs). The code defines persons as including partnerships and, thus, LLCs. If an LLC took out the loan and there were no personal guarantees, the members would not have personal liability on this debt, and basis would be determined under the nonrecourse rules. While the members (partners) would have basis, they would not be considered to be at-risk since a person (the LLC) is personally liable for the debt. Reg. Section 1.465-27 provides that for otherwise qualified nonrecourse financing, the LLC liability for repayment will be disregarded in applying the at-risk rules. The rules will also apply to tiered partnerships and LLCs.

Debt Guarantees & Amounts at Risk

The IRS position on debt guarantees is clear. Prop. Reg. Section 1.465-6(d) provides that a guarantee of debt incurred by others for use in an activity does not increase the amount at risk until the individual has no remaining legal right against the primary obligor. A broader definition of nonrecourse applies in IRC Section 465 since the IRC Section 752 definition of recourse defines it to exist only to the extent that any partner or related person has an economic risk of loss. IRC Section 465, however, defines it as financing with respect to which no person is personally liable (IRC Section 465(b)(6)(B)(iii)).

From reading the proposed regulations, which have been “proposed” for 25+ years, it is clear that guaranteed debt doesn’t provide basis until paid.

However, several issues exist.

- When proposed, LLCs weren’t around. How will the IRS adapt the regulations to reflect the new entity?
- Can the at-risk rules be avoided by providing pass-through liability in the Articles of Organization or Limited Partnership Agreement? Note, however, this would seriously impair the liability protection provided.

On the other hand, the Tax Court has been more willing to look at the economic issues involved in deciding whether or not basis should be increased for guarantees. In the first case it considered, *Brand v. Commissioner*, 81 T.C. 821 (1983), the Tax Court denied basis to limited partners for guarantees, noting that the clear intent of Congress was to deny basis for such guarantees because the partner was entitled to reimbursement from the partnership. Thus, Brand wasn’t a very promising start.

However, since Brand, three Tax Court cases have permitted an increase in basis for guarantees. *Abramson v. Commissioner* (86 T.C. 360 (1986)), *Gefen v. Commissioner* (87 T.C. 1471 (1986)), and *Bennion v. Commissioner* (88 T.C. 684 (1987)) all allowed basis provided that varying tests were met.

Boiled down to the basics, the Tax Court tests are as follows:

- The guarantee must be absolute and unconditional.
- There must be no right of subrogation, contribution, or reimbursement from the entity or other owner.
- The guarantor must bear the ultimate responsibility for the debt, or a portion of the debt if the entity defaults in a worst-case scenario.
- The worst-case scenario is essentially equivalent to the hypothetical transaction in Reg. Section 1.752-2, where all of the entity's assets, including cash, are deemed to be worthless and each owner's responsibility for the various entity obligations is measured by the true economic risk each owner bears.

Passive Activity Loss Limitations

In addition to the basis and at-risk limitations, before a loss may be deducted on the partner's return, the partner must also apply the passive activity loss rules of IRC Section 469.

Partnership losses escaping the basis limitation under IRC Section 704(d) and the at-risk limitations under IRC Section 465 face a third and final obstacle in the form of the passive activity losses under IRC Section 469. If a partnership interest represents a passive activity, the partner's distributive share of partnership losses can be deducted only against current income from other passive activities. The losses cannot be deducted against the partner's earned income or portfolio income.

PRACTICAL APPLICATIONS OF THE BASIS ADJUSTMENT RULES

The basis adjustment rules are complicated and can be daunting in practice. One good way to develop a better understanding of the rules is to apply them in practice. Accordingly, the following two examples work through the basis rules in common situations. The first deals with a real estate partnership and the second deals with an operating business.

EXAMPLE

Section 743 Calculations with a Real Estate Partnership

Busted Partnership owns the building in which they do business. Sam is retiring and wants to sell his 25% interest to Rick. There is an IRC Section 743(b) election in effect at the time.

The basis and FMV of the property at the time of sale is as indicated as follows:

	Inside Basis	Fair Market Value	Outside Basis
Assets:			
Building (net book value)	$100,000	$400,000	
Liabilities and Capital			
Liabilities	$80,000	$80,000	

Sam's Capital Account	$5,000	$80,000	$5,000
Mick's Capital Account	$5,000	$80,000	$5,000
Didi's Capital Account	$5,000	$80,000	$5,000
Barb's Capital Account	$5,000	$80,000	$5,000
Total	$100,000	$400,000	$20,000

Rick purchases Sam's interest for $80,000. Thereafter, the above information looks like this:

	Inside Basis	Fair Market Value	Outside Basis
Assets:			
Building (net book value)	$100,000	$400,000	
Liabilities and Capital			
Liabilities	$80,000	$80,000	
Rick's Capital Account	$5,000	$80,000	$80,000
Mick's Capital Account	$5,000	$80,000	$5,000
Didi's Capital Account	$5,000	$80,000	$5,000
Barb's Capital Account	$5,000	$80,000	$5,000
Total	$100,000	$400,000	$95,000

The IRC Sec. 743 adjustment for Rick would be determined by comparing his inside basis in the asset with his outside basis. Since Rick's inside basis in the building is $25,000 (25% of 100,000) and his outside basis is 100,000 (25% of 400,000) the adjustment would be $75,000 (which also happens to equal the purchase price less the capital account of the old partner, and consequently the amount of gain on which the selling partner will be taxed) Rick would then set up an off-balance sheet asset of $75,000 and depreciate it over 39 years.

Each year, a footnote on page 2 of his K-1 would be prepared to indicate the additional amount of depreciation expense (and preference for alternative minimum) that he should include on his 1040. It's recommended that it be entered as a separate K-1 on the 1040 indicating that it is from the same partnership and relates to an IRC Sec. 754 adjustment.

As a double check, if the building were sold the next day for its FMV of $400,000 then the gains and losses would be as follows:

Dr. Cash	$4,000
Cr. Building	$100,000
Cr. Gain on Sale	$300,000

The gain would be allocated 25% to each partner on his or her K-1. The footnote on the Rick's K-1 would indicate that he has an offsetting LTCL of $75,000.

The net result to all the partners would be as follows:

Partner	Long Term Capital Gain	§ 754 Adjustment	Net Reported
Rick	$75,000	-$75,000	$0
Mick	$75,000	$0	$75,000
Didi	$75,000	$0	$75,000
Barb	$75,000	$0	$75,000
Total	$300,000	-$75,000	$225,000

(Note: Since Sam already recognized a $75,000 gain when he sold his interest, the entire $300,000 gain has been recognized.)

Also note that since Rick purchased his interest from an existing partner, Sam, there is no reallocation of depreciation under Reg. 1.704-3.

EXAMPLE

The Practicalities of the Section 743 Adjustment for an Operating Business

In 1999, Jim Slick, Terri Toga and Mark Slacker started Slick Jim's Clothing, LLC, to sell high- end fashions for men and women, each contributing $50,000 for a 33.33% interest. Slick Jim's soon became the "in" place to buy clothes and the company expanded operations by purchasing another store. To finance the store's acquisition and to help provide additional capital, Slick Jim obtained a $1.7 million mortgage from First Usury Bank. The mortgage is qualified non- recourse financing. Slick Jim's has always allocated all income, gains, losses and deductions 33.33% to each member. Slick Jim's uses the accrual method of accounting and straight-line depreciation for the stores.

In 2016, Terri had had enough of Slick Jim's and wanted to open her own clothing shop "Trendy Terri's." On December 31, Terri (with the agreement of Jim and Mark) sold her interest to Carol Dress, a fashion coordinator. Carol paid Terri cash of $870,000, the fair market value of her share of the net assets in Slick Jim's (in reality, there would probably be a discount for marketability and for owning a minority interest, but these are disregarded here). Slick Jim's agreed to make an IRC Sec. 754 election for 2016. The sale closed on December 31, 2016.

Slick Jim's Balance Sheet as of December 31, 2016 is as follows:

Slick Jim's Clothing, LLC
Balance Sheet
December 31, 2016

	Tax Basis	FMV
Cash	$100,000	$100,000
Accounts Receivable	$35,000	$35,000
Inventory	$125,000	$265,000
Store 1 (including land)	$550,000	$900,000
Less: Accumulated Depreciation	($125,000)	
Store 2 (including land)	$800,000	$1,100,00
Less: Accumulated Depreciation	($145,000)	
Customer List	-	$135,000
Goodwill	-	$1,500,000
Total Assets	$1,340,000	$4,035,000
Mortgage Payable—non-recourse	$1,425,000	$1,425,000
Capital:		
Jim Slick	($28,333)	$870,000
Terri Toga	($28,333)	$870,000
Mark Slacker	($28,333)	$870,000
Total Liabilities and Capital	$1,340,000	$4,035,000

Terri will recognize a gain of $898,333 in 2016 computed as follows:

Cash Sales Price	$870,000
Relief from Liabilities (1/3 of $1,425,000)	$475,000
Total Sales Price	$1,345,000
Less: Basis	
Tax Basis Capital Account	–$28,333
Liabilities	$475,000
Total Basis	$446,667
Taxable Gain	$898,333

Since Slick Jim's will make a Sec. 754 election, Carol will be entitled to a step-up in basis. This adjustment is the difference between Carol's outside basis of $1,345,000 ($870,000 cash paid plus a 1/3 share of the $1,425,000 qualified non-recourse mortgage) and her share of the adjusted basis of partnership property (inside basis of the partnership's assets).

Carol's adjusted basis in the partnership property equals the sum of her share of the partnership's previously taxed capital, plus her share of partnership liabilities. Carol's share of previously tax partnership capital equals (1) the cash she would receive from a liquidation of the partnership following a hypothetical sale, plus (2) the tax loss, including any remedial allocations under Reg. 1.704-3(d), allocated to her from the hypothetical sale, minus (3) the tax gain, including any remedial allocations under Reg. 1.704-3(d), allocated to her from the hypothetical sale. Fortunately, in this case, IRC Sec. 704(c) doesn't enter into the picture, which simplifies things considerably.

If all of Slick Jim's were sold at FMV, the LLC would receive $2,610,000 in cash after payment of all the liabilities. This cash would then be distributed to the partners.

Carol would receive a one-third share, or $870,000 computed as follows:

FMV of Cash	$100,000
FMV of Accounts Receivable	$35,000
FMV of Inventory	$265,000
FMV of Store 1	$900,000
FMV of Store 2	$1,100,000
FMV of Customer List	$135,000
FMV of Goodwill	$1,500,000
Total FMV	$4,035,000
Less: Mortgage	–$1,425,000
Cash Available for Distribution to Members	$2,610,000
Carol's Share of Cash	$870,000

Thus, in Step (1) above, Carol would be entitled to $870,000 in cash upon liquidation of the LLC after a hypothetical sale.

In this example, skip Step (2), since there is no tax loss on the sale.

Since there is a gain, Step (3) would then be computed. In this case, the tax gain would be $2,695,000 of which Carol would be allocated $898,333, her one-third share, computed as follows:

FMV of Cash	$100,000
FMV of Accounts Receivable	$35,000
FMV of Inventory	$265,000
FMV of Store 1	$900,000
FMV of Store 2	$1,100,000
FMV of Customer List	$135,000
FMV of Goodwill	$1,500,000
Total FMV	$4,035,000
Less: Basis	
Cash	$100,000
Accounts Receivable	$35,000
Inventory	$125,000
Stores (1 and 2)	$1,080,000
Customer List	0
Goodwill	0
Total Basis	$1,340,000
Taxable Gain	$2,695,000
Carol's One-third Share	$898,333

Carol's previously taxed capital is ($28,333), computed as follows:

Cash Carol would receive on liquidation	$870,000
Plus any tax loss allocated to Carol	0
Minus any tax gain allocated to carol	–898,333
Previously Tax Capital	–$28,333

Thus, Carol's adjusted basis in the partnership property equals $446,667. This is the sum of her previously taxed capital of $(28,333) plus $475,000, which is her share of the LLC's liabilities. Since her basis in her partnership interest (her outside basis) is $1,345,000, her basis adjustment will be $898,333 ($1,345,0000 – $446,667).

This basis adjustment must be allocated among the assets of the partnership to reduce the difference between the FMV of the assets and their bases. Since there are several assets with a FMV greater than basis, the step-up in basis will need to be allocated among those assets in accordance with the regulations under Sec. 755.

Under Reg. 1.755-1, the allocation of gross value is as follows:

Slick Jim's Clothing, LLC
Allocation of Gross Value
December 31, 2016

Class I Assets—Cash	$100,000
Class III Assets—Accounts Receivable	$35,000
Class IV Assets—Inventory	$265,000
Class V Assets:	
Store 1	$900,000
Store 2	$1,100,000
Class VI Assets—Customer List	$135,000
Class VII Assets—Goodwill	$1,500,000
Gross Value	$4,035,000

Since there is sufficient basis adjustment to allocate to each class, including goodwill, the allocation of the step-up in basis is as follows:

	Tax Basis	Fair Market Value	Difference (Set-Up)
Carol's Share of Ordinary Income Property			
Accounts Receivable	$11,667	$11,667	$0
Inventory	$41,667	$88,333	$46,667
Totals—Ordinary Income Property	$53,333	$100,000	$46,667
Carol's Share of Capital Gain Property			
Store 1 (incoming Land)	$141,667	$300,000	$158,333
Store 2 (incoming Land)	$218,333	$366,667	$148,333
Customer List	0	$45,000	$45,000
Goodwill	0	$500,000	$500,000
Totals—Capital Gain Property	$360,000	$1,211,667	$851,667
Total Step-Up in Basis (Ordinary and Capital)			$898,333

All of the step-up for the ordinary income assets will be allocated to the inventory. Both stores will have an increase in basis. The step-up in basis will be treated as a new asset, which means that it will have a 39-year life and will be depreciated under MACRS. Such additional depreciation allocation should be reported on line 11 of Carol's K-1. The customer lists and goodwill will be amortized over 15 years. Note: If Carol was related to one of the existing owners, the anti-churning rules of IRC Sec. 197 would preclude her from deducting any amortization on the intangibles.

If there had been an insufficient amount of basis to allocate to each class, for example, the interest was purchased at a discount, then the basis would be allocated starting with Class I and continuing as in the computation above until all of the basis had been used. Thus, Class VII would be the Class reduced first (to zero if necessary), then Class VI, etc.

EFFECT ON CAPITAL ACCOUNT

What about the credit side of that entry? Carol didn't put any more money into the partnership. She gave the money to Terri. The most common response will be to credit the capital account of the new partner. That may be the correct answer, but we need to understand how that capital account and the related write-up in assets will function.

Since the transaction is really treated somewhat as though the purchasing partner acquired an interest in the various assets and then contributed them to the partnership, the credit to her capital account is appropriate. That is the amount she should receive upon liquidation, et cetera. However, that amount should be segregated from other capital account balances.

Annually, appropriate depreciation and amortization related to the "Section 754 adjustments" will be the basis for entries to reduce the carrying value of the assets and charge that portion of the capital account attributable to the Section 754 adjustment. Carol's K-1 will report her share of various partnership items and her Section 754 adjustment. That amount will not affect the income of any other partner, so it is not recorded as an expense in the partnership's tax return.

NOTES

Unit

9

Partnership Terminations

LEARNING OBJECTIVES

- **Recognize** events that cause partnerships to terminate for tax purposes.
- **Recognize** the continuation of certain partnerships upon the merger, consolidation, or division of partnerships.
- **Determine** the tax implications of partnership termination.

IN GENERAL

The general rule is that an existing partnership continues to exist for tax purposes until it is terminated within the meaning of the code (IRC Section 708(a)). There is a presumption of continuity unless one of the events that cause termination occurs.

EVENTS CAUSING PARTNERSHIP TERMINATION

IRC Section 708(b) specifies events that cause termination of a partnership. Under the general rule of termination, a partnership is terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners. The 2017 Tax Cuts and Jobs Act repealed the rule formerly found in Section 708(b) which provided that the partnership terminated if within a 12-month period there was a sale or exchange of 50 percent or more of the total interest in partnership capital or profits. This rule was repealed for partnership taxable years beginning after 2017.

A partnership is not terminated for tax purposes merely because it is dissolved under state law. Although a partnership may be dissolved under state law by a partner's death, withdrawal, insolvency, or by some other act, a tax termination will occur only under the circumstances listed, with one exception. The exception involves the termination of partnerships as a result of a merger or division. In those cases, the code provides specific termination rules in the event of merger of two or more partnerships, or in the division of a partnership into two or more partnerships. Also, it's important to remember that termination and liquidation are not interchangeable terms.

The partnership that results from the merger or consolidation of two or more partnerships is considered to be a continuation of any merging partnerships whose members own 50% or more of the capital and profits of the resulting partnership.

Any partnership resulting from the division of a partnership into two or more partnerships is treated as a continuation of the original partnership, unless the members of the resulting partnership owned 50% or less of the capital and profits of the original partnership.

Any resulting partnership that is not a continuation of the original partnership is considered to be a new partnership.

TERMINATION BY DISCONTINUATION OF BUSINESS: SECTION 708(B)(1)

A partnership terminates if "no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership." These provisions describe two circumstances that cause termination.

Partnership Operations Discontinued

One occurs when the business of the partnership is discontinued. Where it is advantageous to keep a partnership open, expect the IRS to argue that even minimal activity is sufficient to prevent a termination. For example, in *7050, Ltd., v. Commissioner*, T.C. Memo 2008-112 (2008), the Tax Court found that simply keeping an inactive currency account was sufficient to prevent the termination of a partnership, noting that such minimal activity was enough to keep the entity open for tax purposes.

The regulations illustrate a termination caused by the discontinuation of the partnership (Reg. Section 1.708-1(b)(1)). The example involves a partnership in which two partners each own a 20% interest and a third partner owns a 60% interest. The 60% partner purchases the interests of the two 20% partners. The partnership is terminated as of the date that the 60% partner purchases the interests of the two 20% partners. No part of the business is carried on by any of the partners "in a partnership" from that date.

In Rev. Rul. 99-6, 1999-1 C.B. 432, the IRS provided detailed guidance on how a multimember limited liability company (LLC) converts to a single member LLC (a disregarded entity) upon the purchase, et cetera, of all but one of the members' interests.

Only One Remaining Owner

The other is when the business is continued but not "in a partnership" by any of the partners. This usually occurs when the interests of all but one partner are liquidated or purchased by the remaining partner and the business is continued as a sole proprietorship.

Death or retirement of a partner in a two-partner partnership typically converts the entity into a proprietorship under state law. The same events generally do not result in immediate termination of the partnership for tax purposes, however. Tax termination occurs only upon sale of the deceased partner's interest to the surviving partner.

No termination occurs, however, if the deceased partner's estate or other successor in interest continues to share in the profits and losses of the partnership. If the deceased or retiring partner's interest is liquidated under Section 736, the partnership continues until the liquidation process is completed.

The tax year is considered terminated as to the interest of the deceased partner upon death.

Determination of Termination Date

The courts have permitted partnerships wide latitude in determining when the partnership terminates. For example, the partners in a partnership with a note receivable from the sale of their business could keep the partnership alive by permitting the partnership to collect the note until paid in full (*Baker Commodities v. Commissioner*, 415 F.2d 519 (CA9, 1969)).

On the other hand, the partnership could distribute the note to the partners in liquidation at any time, thus terminating the partnership. However, this tremendous flexibility comes with a significant caveat. The IRS will likely apply the anti-abuse regulations to change the termination date if the partnership is attempting to avoid or evade tax by manipulating the termination date.

Tax Consequences of Partnership Termination

If a partnership terminates because it ceases to carry on any business, financial operation, or venture, its taxable year closes with respect to all partners.

MERGERS OF PARTNERSHIPS

The general rule of IRC Section 708 is that the resulting partnership is considered to be a continuation of the partnership whose partners own interests in the resulting partnership totaling more than 50% of the capital and profits. The regulations provide that if the resulting partnership can be considered the continuation of more than one partnership (partners have interests in more than one of the merging partnerships), then the resulting partnership will be considered the continuation of the partnership that contributes the most value based upon the FMV of the assets of the resulting partnership.

If none of the partners meet the 50% test, then the resulting partnership is considered to be a new partnership and the merged partnerships are terminated.

The regulations deal with the form of the merging transaction. The IRS generally will respect the form chosen by the parties as long as it is allowable by local law. Reg. Section 1.708-1(c) (3) provides two types of allowable merger transactions. Unless the partnership elects to use the assets-up form, the IRS will apply the assets-over form because the assets-over form continues the old partnership's asset basis. The basic premises for the two types of transactions are as follows.

Assets-Over Form

If the partnerships merge under local law without a particular form designated by such law, then the regulations apply an assets-over approach and provide for no gain or loss and a carryover basis. The merged or consolidated partnership that is considered terminated is deemed to contribute all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, which is immediately distributed in liquidation to its partners.

If one or more of the partners in the terminating partnership have their interest purchased by the resulting partnership as part of the transaction, the sale will be respected if it is part of the contract of merger. Under Reg. Sections 1.752-1(f) and (g), partners in an assets-over merger net their partnership liabilities, thus producing gain only if their deemed distribution arising because of a net decrease in partnership liabilities exceeds their partnership basis.

If any merging partnership has a built-in loss in its assets, the inside basis of the assets for the merged partnership is FMV, and the built-in loss is allocated only to the partners in the merging partnership (IRC Section 704(c)(1)(C)). The assets-over form also creates a split-holding period for the interests because the new entity will be a combination of holding periods for contributed assets (Reg. Section 1.1223-3) and distributed assets (IRC Section 735(b)). No IRC Section 704(c) gain should be recognized, but under regulations yet to be issued, the IRS has indicated that it will require new IRC Section 704(c) allocations to the partners of the merged partnership (Notice 2005-15). However, Proposed Reg. Section 1.704-4(c)(4) makes it clear that IRC Sections 704(c)(1)(B) and 737 don't apply to an assets-over merger. Thus, there is no new seven-year holding period, although any new IRC Section 704(c) gain would start from the merger date.

Assets-Up Form

If the terminating partnership distributes all of its assets and liabilities to its partners, followed by a contribution by the partners to the resulting partnership, the Service will apply an assets-up approach and ignore the transitory ownership by the partners. This will be treated as liquidation and gain or loss may be recognized. Basis will not carry over but will be determined by the liquidation. Another problem is that when a partner receives an interest in the merged partnership that has contributed IRC Section 704(c) property, gain may have to be recognized under IRC Section 704(c))(1)(B) or IRC Section 737. Likewise, the deemed distribution and recontribution of liabilities under IRC Section 752 creates a higher risk that a partner will recognize taxable income than under the asset-over form. All of these issues raise a simple question: why use this when the assets-over method is so taxpayer friendly?

IRS Ability to Recast

The IRS reserves the right to recast any transaction to reflect the real economic relationships between or among the partners, even if the transaction is discussed in the regulations. Recasting the transaction will likely occur if the transaction is part of a larger transaction, one of a series of transactions, or is inconsistent with the form prescribed by the regulations.

Other Issues Arising from a Merger

A number of other issues arise upon a merger of partnerships. Some of these issues are detailed in the following sections.

Depreciation in Merged Entities

The continuing partnership in a merger will continue to use the same depreciation methods, conventions, periods, et cetera, as prior to the merger because nothing has changed—it's the same business. Partnerships that are merged into the new entity are treated as contributing their property in exchange for a partnership interest under IRC Section 721, so those depreciation methods, periods, conventions, et cetera, also carry over. Likewise, any basis adjustments made under IRC Section 754 by either the merged or continuing partnerships carry over to the merged partnership (PLR 9444013).

Reporting Partnership Mergers

If the new partnership is a continuation of one of the merging partnerships, the new partnership is required to attach a statement to its tax return for the year including the merger date that states it is a

continuation of the merging partnerships, as well as the names, addresses, and identification numbers of all of the merging partnerships. The pre- and post-merger distributive shares of all of the partners must also be included.

Disregarded Entities

The regulations allow mergers with disregarded entities despite the fact that they are not corporations. The regulations require that the transaction must be under applicable state law (Reg. Section 1.368-2). For disregarded entities, the applicable terms are "combining entity," which is defined as a business entity classified as a corporation that is not disregarded for tax purposes (Reg. Section 1.368-2(b)(1)(i)(B)) and "combining unit," which is the combining entity and all disregarded entities whose assets are deemed to be owned by the combining entity (Reg. Section 1.368-2T(b)(1)(i)(C)). In a transaction, there is a transferor unit and a transferee unit (Reg. Section 1.368-2(b)(1)(ii)(A)).

A key factor to remember in applying these rules is that the entity will be treated as if it is the type of entity that it has "checked the box" to become under the check-the-box regulations described earlier. These mergers work for "like" tax entities even if they are different legal entities. Additionally, mergers will not have the expected tax result most often if the entities are different tax entities even though both have the same form legally.

EXAMPLE

Merger of Different Entities into a Corporation

Smith Co., a domestic corporation, is merged into Jones, LLC under the laws of State A. Jones, LLC is wholly owned by Jane Co., a domestic corporation, and is a disregarded entity. Under the applicable laws of State A, all of the assets and liabilities of Smith Co. become those of Jones, LLC, and Smith Co. ceases to have a legal existence. The shareholders of Smith Co. receive Jane Co. stock in exchange for their Smith Co. stock. This is a valid A reorganization.

EXAMPLE

Merger of Different Entities into a Partnership

Assume the same facts as in the first example except that Jane Co. is not a corporation but a partnership under the laws of State A. Now the transaction doesn't qualify as an A reorganization because there is not a "combining unit" since neither Jones, LLC nor Jane Co. are corporations.

PARTNERSHIP DIVISIONS

As with mergers, a division of a partnership can result in a continuation of that partnership.

If the partners of only one of the new partnerships resulting from the division hold more than 50% of the capital and profits interests of the original partnership, then that partnership is a continuation of the original partnership and called the "divided" partnership. If more than one of the new partnerships meets the more-than-50% test, then the partnership with the greatest asset FMV, net of liabilities is the continuing partnership. The divided partnership keeps the original partnership's employer ID number and is the continuation of the old partnership. The other partnerships would be new partnerships for tax purposes.

If none of the new partnerships meet the more-than-50% test, then there is no continuation of the old partnership and the old partnership is deemed to terminate and liquidate for tax purposes. Of course, this means a final return must be filed.

Assuming that there is a continuation, the partnership deemed to be the continuation files a tax return for the year with a statement that it is a continuation of the old partnership. The old partnership's elections, et cetera, carry over to the continuing partnership. All of the other partnerships are new partnerships with filing responsibilities starting on the date of division. The new partnerships, unlike the continuing partnerships, are no longer covered by the original partnership's elections.

A partnership division, like a partnership merger, can use the assets-over method or the assets-up method. Unless the assets-up method is selected, the transaction will be classified as an assets-over transaction. If there is at least one continuing partnership, the divided partnership is deemed to contribute assets and liabilities to one or more partnerships in exchange for interests in those partnerships and then to distribute those interests to some or all of the divided partnership's partners in liquidation of those partners' interests in the partnership.

If none of the partnerships are a continuing partnership, then there is a deemed contribution of property and liabilities for interests in the new partnerships, followed by a liquidation of the old partnership by distribution of those interests to its partners.

As with a merger, the election of the assets-up method will be respected when the divided partnership distributes assets to the partners (even if it's only to some of the partners) in liquidation of the partners' interests in the partnership and, immediately following the distribution, the partners contribute the assets to a new partnership in exchange for an interest in the partnership. A critical requirement for the assets-up method to apply is that all of the assets that are distributed must be contributed to the new partnerships.

Where there is no continuing partnership, the assets-up method will be respected for tax purposes when the old partnership distributes its assets to some or all of the partners in liquidation of their interests in the partnership and the partners immediately contribute the assets to a new partnership or partnerships in return for an interest in those partnerships. The assets over rule discussed earlier applies to this transaction as well.

Unit 10

Anti-Abuse Partnership Regulations

LEARNING OBJECTIVES

- **Understand** the implications of the anti-abuseregulations.
- **Analyze** situations to determine if a tax position is subject to IRS attack under theserules.

ANTI-ABUSE PARTNERSHIP REGULATIONS

The anti-abuse regulations authorize the IRS to reconfigure a transaction if it is being used to circumvent the intended purpose of subchapter K, or indeed the intended purpose of the whole Internal Revenue Code (IRC). They are targeted at certain transactions that the IRS believes are abusive, although they are very broadly drafted. Certain specific kinds of transactions were apparently the intended targets.

In *Brown Group, Inc. v. Commissioner*, 102 T.C. 616 (1994), the partnership framework was used to avoid taxation of passive income that had been received by a controlled foreign corporation. The IRS nonacquiesced in the case and continues to believe that the presence of a partnership in the chain of foreign corporation does not affect the application of Section 951. The IRS apparently felt that there was no statute that it could use to attack this transaction, which it believed was clearly abusive and a sanctification of form over substance.

The IRS was concerned about the use of Sections 732, 733, and 734 to bump basis from one type of property to another. The existing statutory scheme does not allow the IRS to attack these shifts comprehensively, at least in the opinion of the IRS National Office.

The IRS announced in Notice 90-56, 1990-2 CB 344 that the Service would not respect a transaction involving the acceleration of gain through an installment sale by a partner who was then redeemed out of the partnership.

Notice 2004-67 lists 30 listed transactions that have been identified as tax-avoidance transactions. Many of those rely on abuse of the partnership form to achieve their abusive tax avoidance goals. Participation in any such transaction must now be disclosed using Form 8886. Failure to disclose will subject the taxpayer and the preparer to penalties and disciplinary action respectively (IRC Sections 6662A and 6707A).

The major impetus for these regulations, the notices, and enhanced penalties in the statute was large-deduction, one-shot partnerships put together by major investment banking, accounting, and law firms. These firms have used their experience with highly sophisticated financial instruments and their immense economic resources to wring major advantages from one-shot deals, sold with confidentiality agreements, which they milk for maximum return but then do not repeat, at least in any recognizable form.

The IRS has played catch-up to these transactions most of the time but caught a break in the collapse of Enron when many previously hidden "confidential" documents disclosed the magnitude of the tax-avoidance industry.

THE IRS'S APPROACH TO PARTNERSHIP TRANSACTIONS: SUBSTANCE OVER FORM

The final Section 701 regulations attempt to ensure that the partnership itself is bona fide and that each partnership transaction, or series of related transactions, is entered into for a substantial business purpose. Effectively, these regulations are an application of the substance-over-form doctrine.

Intent of Subchapter K Test

The provisions of Subchapter K must be applied to partnership transactions in a manner consistent with the intent of Subchapter K.

Subchapter K is intended to permit taxpayers to conduct joint business—including investment—activities through a flexible economic arrangement without incurring an entity level tax. Implicit with this intent are three requirements.

- The partnership must be bona fide and each partnership transactions must be entered into for a substantial business purpose.
- The form of each partnership transaction must be respected under substance-over-form principles.
- The tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partners' income, except to the extent that a provision of Subchapter K that is intended to promote administrative convenience or other policy objectives causes tax results that deviate from that requirement.

Under the authority of these regulations, the Commissioner has authority to recast transactions that attempt to use partnerships in a manner inconsistent with the intent of Subchapter K as appropriate to achieve tax results that are consistent with this intent, taking into account all the facts and circumstances. Effectively, the IRS can disregard the form of the transaction.

In that case, the IRS may treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the code or regulations. However, the IRS's power to treat a partnership as an aggregate of its partners does not apply to the extent:

- a provision of the code or regulations prescribes the treatment of the partnership as an entity, and
- that treatment and the ultimate tax results, takinginto account all of the facts and circumstances, are clearly contemplated by the IRC.

It appears that the IRS will continue to look to the intention of the parties to determine the application of these anti-abuse rules. The IRS has noted, in responding to criticisms about these regulations that they only apply if:

- the taxpayer has a principal purpose to achieve a substantial federal tax reduction and
- the tax reduction is inconsistent with the intent of Subchapter K.

Tax Efficiency

Having a principal purpose to use a bona fide partnership to conduct business activities in a manner that is more tax efficient than any alternative means available does not establish that the resulting tax reduction is inconsistent with the intent of Subchapter K.

Scope Expansion

The IRS continues to expand the scope of the anti-abuse regulations. In May 2008, for example, the Treasury issued new proposed regulations under its anti-abuse authority. Proposed Reg. Section 1.704-3 provides that the IRS can recast an allocation under IRC Section 704(c) when it results in a substantial reduction in the net present value of the partners' federal tax liability that is inconsistent with the purposes of Subchapter K. Thus, for example, the use of the remedial method of allocation may be challenged where one allocation is made to one partner and the offsetting allocation is made to a related partner. The proposed regulations also require that the effects of an allocation be considered on both direct and indirect partners (Proposed Reg. Section 1.704-3(a)(10)).

On April 30, 2010, the U.S. District Court for Southern Mississippi applied the anti-abuse regulations to Nevada Partners Fund, LLC, ruling that the IRS recasting of a tax shelter transaction to produce tax pursuant to Section 1.701-2 of the Income Tax Regulations was appropriate (*Nevada Partners Fund, LLC et al. v. United States*; No. 3:06-cv-00379, 4/30/2010). The court's analysis in this matter is a comprehensive review of tax litigation involving IRS attacks on partnerships that are structured to produce tax losses and little else. This affirmation of the anti-abuse regulations (Section 1.701-2) is an important matter and should serve as a wake-up call to those who would attempt to use the partnership form to claim "unintended tax results."

WHAT ARE THE POTENTIAL CONSEQUENCES OF AN IRS APPLICATION OF THE REGULATIONS?

Even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the IRS can find it violates the intention of Subchapter K. The IRS can take any of the following actions if it determines such actions are necessary (based on the facts and circumstances) in order to achieve tax results that are consistent with the intention of Subchapter K.

- The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners. For example, in CCA 200704028, the IRS concluded that a partnership created to acquire and allocate state historic tax credits wasn't a partnership and the transaction was recast as a purchase and sale of the credits.
- One or more of the purported partners of the partnership should not be treated as a partner.
- The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income.
- The partnership's item of income, gain, loss, deduction, or credit should be reallocated.
- The claimed tax treatment should otherwise be adjusted or modified.

How will the IRS be able to tell whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partner's aggregate federal tax liability in a manner inconsistent with the intent of Subchapter K? Presumably, the answer is that determination is based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The following factors may show that the partnership was used in a manner inconsistent with the purpose of Subchapter K.

- The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly.
- The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result were integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax result and whose interest in the partnership was liquidated or disposed of would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners.
- One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership; are substantially protected from any risk of loss from the partnership's activities, through distribution preferences, indemnity or loss guaranty agreements, or other arrangements; or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital.
- Substantially all of the partners, measured by number or interests in the partnership, are related, directly or indirectly, to one another.
- Partnership items are allocated in compliance with the literal language of Reg. Sections 1.704-1 and 1.704-2, but with results that are inconsistent with the purpose of Section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (i.e., a foreign person, an exempt organization, etc.)
- The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained, directly or indirectly, by the contributing partner or a related party.

- The benefits and burdens of ownership of partnership property are in substantial part shifted to the distributee partner before or after the property is actually distributed to the distributee partner or a related party.

The IRS announced in Announcement 95-8 (Federal Register, April 13, 1995) that the Section 701 anti-abuse regulations were amended to clarify that the rules therein did not apply to family partnership transactions. The same announcement deleted two family partnership examples from the regulations. Most practitioners believe that this deletion, brought about through strong political pressure by the bar and the CPAs, does not mean the IRS will not eventually launch a widespread attack on family partnerships that are perceived to be abusive.

IMPLICATIONS OF THE ANTI-ABUSE RULES

Although the preamble to the anti-abuse regulations clearly asserts that the regulations will apply to a relatively small number of transactions, the vagueness and ambiguity in the regulations expand the potential scope tremendously. Since the presence of a tax-avoidance motive triggers the application of the anti-abuse regulations, most economic transactions will potentially be subject to these rules, given the pervasiveness of tax impact on daily life. The IRS has expanded its application of the anti-abuse regulations. Initially, the IRS required National Office review and oversight of any application of the partnership anti-abuse regulations (Announcement 94-87).

However, the IRS announced that agents will have blanket authority, without National Office review, to apply the anti-abuse regulations in several areas:

- Losses claimed from state tax credit deals
- Son-of-boss transactions
- Partnership straddle shelters
- Excess losses through the use of S corporations
- Compensatory options sold to related parties
- Foreign corporations creating deductions for U.S. dealings where the interest payments are limited under IRC Section 163(l)
- Redemption bonus optional basis transactions (improper use of a Section 754 election)

This expanded use of its self-generated authority under the anti-abuse regulations concerns a number of practitioners—given the potential scope of the rules. Thus far, there has been little judicial review of whether the regulations are valid. In *Jade Trading, LLC v. United States*, 60 Fed. Cl. 558 (2004), the partnership challenged the validity of the regulations. However, before the court could rule, the IRS withdrew its assertion that the regulations should apply in that case. Further, in *Countryside Limited Partnership v. Commissioner*, T.C. Memo 2008-3 (2008), the Tax Court declined to permit the IRS to use the anti-abuse regulations to recast various partnership transactions, finding that there was a bona fide nontax reason for the transactions.

The IRS's decision to grant blanket authority to apply the anti-abuse regulations coupled with a more aggressive IRS approach to enforcement means that revenue agents will raise the specter of the anti-abuse regulations more frequently. This, coupled with the vague language in the regulations, means

that more and more partnerships may find their transactions challenged simply because the IRS doesn't like the way a transaction turns out.

APPLICATION OF THE REGULATIONS THROUGH EXAMPLES

EXAMPLE

Bona Fide Partnership

FACTS: Presto, L.P., a limited partnership, has two partners, Magic, Inc. and Merlin. Information related to them is given in the following table:

Type of Partner	Percentage of Ownership	Business Purpose
Magic = Corporate general partner	1%	
Merlin = Individual limited partner	99%	1. Provide Merlin with limited liability 2. Subject the income to only one level of tax

Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. Although Merlin retains, indirectly, substantially all of the benefits and burdens of ownership of money or property he contributed to Presto, the decision to organize and conduct business through Presto under these circumstances is consistent with this intent.

Therefore, the transaction meets the three requirements.

- The partnership is bona fide.
- The form of each partnership transaction must be respected under substance-over-form principles.
- The tax consequences accurately reflect the partners' economic agreement and clearly reflect the partners' income.

EXAMPLE

Flexibility of Subchapter K

Nottingham Shire, Inc. and Robin form the Hood Partnership to conduct a bona fide business.

Type of Partner	Explanatory Remarks	Business Purpose
Nottingham Shire, Inc. = S Corporation		Choose partnership form rather than admit Robin as a shareholder in Nottingham, as a means of retaining the benefits of a subchapter S for Nottingham and its shareholders.
Robin = A resident alien	Robin can't be a shareholder in Nottingham	

Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. The decision to organize and conduct business through a flexible economic arrangement is consistent with this intent.

It may be argued that the form of the partnership transaction should not be respected because it does not reflect its substance, inasmuch as application of the substance-over-form doctrine arguably could result in Robin being treated as a shareholder of Nottingham. That situation would invalidate Nottingham's Subchapter S election. But the facts indicate otherwise. The shareholders of Nottingham are subject to tax

on their pro rata shares of Nottingham's income and Robin is subject to tax on Robin's distributive share of partnership income. Thus, the form in which this arrangement is cast accurately reflects its substance as a separate partnership and S corporation.

EXAMPLE

Allocations Under Subchapter K Are Valid

Fast and Faster contribute equal amounts to Shakers, a bona fide partnership formed to make joint investments. Shakers pays $100 for a share of Quickbuck's common stock, an unrelated corporation, which has historically paid an annual dividend of $6. Shakers specially allocates the dividend income on the Quickbuck's stock to Fast to the extent of the London Interbank Offered Rate (LIBOR) on the record date, applied to Fast's contribution of $50, and allocates the remainder of the dividend income to Faster. All other items of partnership income and loss are allocated equally between Fast and Faster. The allocations under the partnership agreement have substantial economic effect within the meaning of Section 1.704-1(b)(2).

In addition to avoiding an entity-level tax, a principal purpose for the formation of the partnership was to invest in Quickbuck's common stock and to allocate the dividend income from the stock to provide Fast with a floating rate return based on LIBOR, while permitting Fast and Faster to claim the dividends-received deduction under Section 243 on the dividends allocated to each of the partners.

Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. The decision to organize and conduct business through Shakers is consistent with this intent. Section 704(b) and its regulations permit income realized by the partnership to be allocated validly to the partners separate from the partners' respective ownership of the capital to which the allocations relate, provided that the allocations satisfy both the literal requirements of the statute and regulations and the purposes of those provisions. The IRS, therefore, cannot recast the transactions.

NOTES

Unit 11

Partnership Examinations & the Centralized Partnership Audit Regime

LEARNING OBJECTIVES

- **Understand** the various types of partnership examinations and which partnerships they apply to.
- Be able to **advise** clients subject to or undergoing a TEFRA examination.
- **Understand** issues that exist under the BBA examination regime.

Partnerships do not pay income taxes; rather, they pass through information to the partners who, if they are taxable entities, then pay any taxes. Thus, partnerships are going to be different from a standard examination of a taxable entity such as a C corporation, trust, estate, or individual entity.

This clear break between the return on which the income, expenses, and credits are computed and the return on which the tax will ultimately be paid has bedeviled the IRS as the agency has tried to come up with ways to effectively examine partnerships.

Also, over time, the nature of partnerships has changed. Originally, partnerships were generally limited to very small businesses with only a few partners. But then advisers discovered that partnership rules offered many options in designing and marketing tax shelters. More recently, large publicly traded partnerships (especially in the areas of oil and gas exploration) have proliferated.

The changing nature of partnerships has led Congress twice to enact comprehensive reforms of tax examinations of partnerships. First, in the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA), Congress created a system that allowed the IRS to conduct the examination of issues related to income, deductions, and credits at the partnership level rather than having to open an examination of each partner's return. However, once the adjustments were computed at the partnership level, the IRS would then look to collect the tax due from each of the partners based on that partner's share of the adjustments.

These rules (most often referred to as the TEFRA rules) allowed the IRS to deal with the large number of partnership tax shelters that had sprung up during the 1970s and into the early 1980s—a

trend that would not see a significant decline until the passage of the Section 469 passive activity rules in the Tax Reform Act of 1986. Such partnerships, while having more partners than the four- or five-partner partnerships prevalent in the 1950s, still had enough to make it feasible to compute an adjustment for each affected partner. The nature of the shelters assured that partners would remain relatively stable, since actually disposing of the interest generally unwound the tax shelter, creating what would be referred to as "phantom income," though most often it was effectively a recapture of similarly "no cash" deductions previously taken.

More recently, Congress has again revisited the partnership audit rules, enacting a new system to deal with the explosion of publicly traded partnerships. These entities often have many thousands of partners, with a large number both buying and selling interests over very short time periods. The huge number of partners, some of whom had interests for only a few days, rendered it extremely costly and time consuming for the IRS to attempt to collect any tax due at the end of the exam. Due to this, the IRS actually examined very few of these entities and Congress became concerned that this lack of an examination function was causing a substantial shortfall in taxes collected related to such partnerships.

In 1997, Congress had enacted a streamlined "elective large partnership" audit regime, but since it was optional (and the IRS wasn't examining partnerships not in that regime), very few partnerships actually elected to come under those rules.

Thus, as part of the Bipartisan Budget Act (BBA) of 2015, Congress made another fundamental change. Having centralized the examination of income, expenses, and credits in 1982, Congress went one step further and enacted a new system (often referred to as the Centralized Partnership Audit Regime, or CPAR) that now has the IRS assess tax directly against the partnership at the end of the examination. This was not an elective system for partnerships, but rather a mandatory system that replaced both the TEFRA and elective large partnership audit regimes.

In both the TEFRA and BBA systems, Congress allowed certain small partnerships to remain subject to the original 1954 examination system where the IRS opens an exam for each partnership. Under the TEFRA rules, this exemption automatically applied to qualified partnerships. In the new BBA regime, small partnerships now have to affirmatively elect out of the BBA examination regime each year if the partnership does not want to fall under the new rules.

In this unit, we'll look at the three examination regimes in place today: the original 1954 code partnership examination system, the TEFRA rules (which are scheduled for repeal for years beginning on or after January 1, 2018), and the BBA rules (which are elective for years beginning after November of 2015 and before January 1, 2018, and mandatory for later years).

TRADITIONAL PARTNERSHIP EXAMINATIONS

Under the original partnership examination structure in the 1954 code, the aggregate theory of taxation took precedence. That is, a partnership exam represented a series of individual tax exams for each of the partners.

Thus, each partner had a separate exam, defending her own income, deductions, and credit that flowed through from the partnership. While the IRS would generally open up an exam of all partners at the same time, it still represented a set of individual examinations with each partner having leeway on her own strategy.

As was noted at the beginning of this unit, this system remains an option for some small partnerships that meet the requirements imposed by each of the two subsequent regimes. However, those small

partnerships have an option to elect to come under the TEFRA consolidated audit rules, but under the BBA rules will have to make an election not to have the BBA rules apply.

REVISED CONSOLIDATED EXAMINATIONS (COMPREHENSIVE PARTNERSHIP AUDIT REGIME (CPAR))

The Bipartisan Budget Act of 2015 will repeal the TEFRA partnership audit rules and elective large partnership audit rules, replacing them with a new set of provisions dealing with examinations of partnership returns, referred to as the comprehensive partnership audit rules (CPAR). These rules were first effective for returns filed for tax years beginning on or after January 1, 2018.

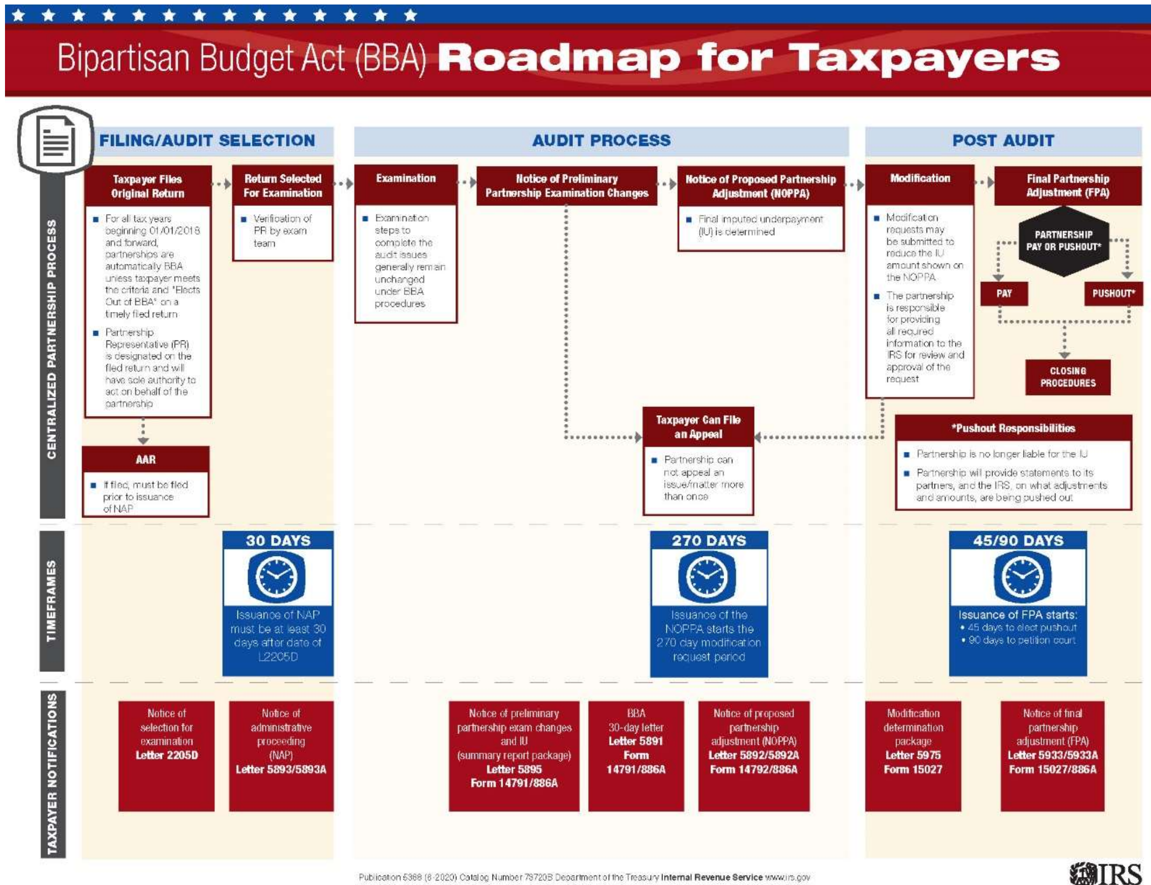
A new Subchapter C was added to Chapter 63 of the IRC to provide for this new set of procedures to be used.

We note that the 2020 CARES Act enacted certain changes that can affect partnerships. For example, Section 163(j) may limit the deductibility of business interest expense to the sum of business interest income, 30% of the taxpayer's adjusted taxable income ("ATI") for the taxable year, plus certain floor plan financing interest. There were temporary changes to these rules and special application of the temporary CARES Act changes as they apply to partnerships. However, the CARES Act did not per se alter the centralized partnership audit regime that is our focus.

We note that the CARES Act retroactively classified qualified improvement property placed in service in 2018 or later as 15-year property eligible for 100% bonus depreciation (Sec. 168(e)'). Rev. Proc. 2020-23 permits partnerships subject to the centralized audit regime to file amended partnership returns and issue amended K-1s if done by September 30, 2020. This is instead of filing an administrative adjustment request (AAR).

In June 2020, the IRS released a single page publication (Publication 5388)[114] that provides a general outline of the overall BBB 2015 CPAR examination system.

[114] Publication 5388, Bipartisan Budget Act (BBA) Roadmap for Taxpayers (6-2020), https://www.irs.gov/pub/irs-pdf/p5388.pdf (retrieved July 26, 2020)



Revisions to Already Filed Partnership Returns After Due Date

In April 2020, the IRS published an updated memorandum issued for all LB&I and SB/SE frontline managers and examiners related to the 2015 BBA CPAR system.[115] The memorandum provides information on how taxpayer-initiated revisions to partnership returns are processed.

For partnership returns filed for years beginning on or after January 1, 2018, the memorandum provides the following analysis for which audit system applies to a partnership looking to revise its returns:

- If a partnership did not elect out of the BBA centralized partnership audit regime under IRC Section 6221(b) (which could simply be because the partnership was not eligible to opt out), the partnership must file an Administrative Adjustment Request (AAR), and the revision will be governed by the BBA centralized partnership audit regime.

- If the partnership *validly* elected out of the BBA centralized partnership audit regime under Section 6221(b), the partnership files an amended partnership return, and the BBA centralized partnership audit regime does not apply.[116]

[115] "Memorandum for All LB&I and SB/SE Frontline Mangers and Examiners," April 1, 2020, https://www.irs.gov/pub/foia/ig/spder/lbi-04-0320-0005.pdf (retrieved June 21, 2021)
[116] "Memorandum for All LB&I and SB/SE Frontline Mangers and Examiners," April 1, 2020, p. 4

Although the guidance would suggest that those under the BBA would file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjusted Request (AAR)* in all cases, that is not the case in all situations. In fact, Form 1065-X, *Amended Return or Administrative Adjustment Request*, in some cases is how the AAR is filed—and it's not a choice.

Rather, the IRS provides the following guidance on their website.[117]

> How the partnership representative files an AAR depends on how the partnership tax return was filed.
>
> For electronic returns:
>
> - Complete and submit Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, and Form 1065, *U.S. Return of Partnership Income*, check box G(5) "Amended return" section.
>
> For paper returns:
>
> - Complete and mail Form 1065-X, *Amended Return or Administrative Adjustment Request (AAR)*, to the service center address where the original return was mailed.[118]

2018 CONSOLIDATED APPROPRIATIONS ACT CHANGES TO CPAR

Congress passed technical corrections to the original provisions in the 2018 Consolidated Appropriations Act (Pub. L. 115-141) that dealt with a number of the issues that appeared to exist in the original text. These changes are to be treated as if they had been part of the Bipartisan Budget Act of 2015 that brought the CPAR system into the law.

Key changes in the technical corrections include:

- The new text removes the term *partnership income, gain, loss, deduction and credit* that was used throughout the provisions to explain the scope of the law. It is replaced with the TEFRA-style term *partnership-related item*. A partnership-related item is "any item or amount with respect to the partnership (without regard to whether or not such item or amount appears on the partnership's return and including an imputed underpayment and any item or amount relating to any transaction with, basis in, or liability of, the partnership) which is relevant (determined without regard to this subchapter) in determining the tax liability of any person under chapter 1" and "any partner's distributive share of" any such item or amount. [IRC Section 6241(2)] The less specific nature of the description would appear to allow the IRS to address more items in a partnership exam than under the original language.

- The new changes make clear that the CPAR rules will not apply to other taxes, though changes to such taxes that would be triggered by a CPAR exam could be dealt with in a separate examination context. This is the position the IRS had taken in the original proposed regulations. Taxes that are excluded from CPAR include self-employment taxes, the net investment income tax, and various withholding taxes.

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[117] "File an Administrative Adjustment Request," IRS webpage, https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request (retrieved June 21, 2021)
[118] "File an Administrative Adjustment Request," IRS webpage

- The law also clarifies that, under CPAR, there will not be a netting of capital gain/loss and ordinary gain/loss items to determine the imputed adjustment.

- The rules also clarify that for the amended return option for removing items from the partnership level imputed adjustment to be effective, the partner must file amended returns for all affected years, and all taxes, interest, and penalties must be paid by that partner. A failure to meet those requirements will result in the item(s) remaining in the imputed underpayment calculation. On the positive side, the law also adds a new alternative method (a "pull-in" as opposed to "push-out" adjustment) where individual partners could, without having to actually file amended returns, pay the appropriate amount of tax and make adjustments to attributes.

- Unless otherwise provided by the IRS, if an adjustment could be subject to a partner level limitation (such as those related to passive activities), then it will not be taken into account in computing the partnership's imputed underpayment.

Advisers who have looked into these rules previously need to take a second look to determine the effect of the technical corrections.

Determination at the Partnership Level

By default, rather than having a partnership exam result in tax being assessed at the partnership level, the new procedures will have the partnership pay a computed tax due at the end of any partnership examination (IRC Section 6221(a)).

While this is the default treatment, there are options.

Opting Out for Qualifying Partnerships

Under the prior TEFRA partnership rules, the rules specifically did not apply to a partnership that met certain criteria (less than 10 owners and no disqualified owners) unless the partnership elected to be treated under those procedures (an opt-in system). Under the new rules a partnership with less than 100 partners that meets other criteria may elect to not be covered by these rules (an opt-out system). (IRC Section 6221(b))

To be eligible for the election, the following must be true.

- The partnership must make an election out of the new provisions.

- The partnership must be required to furnish 100 or fewer K-1s for the year.

- Each of the partners is an individual, C corporation; any foreign entity that would be treated as a C corporation if it was domestic; an S corporation; and an estate of a deceased partner (IRC Section 6221(b)(1)). The IRS is granted authority to expand this list to include other types of partners (IRC Section 6221(b)(2)(C)).

- The election must be made on a timely filed return and include the name and identification number of each partner. The partnership must also notify each partner that the election has been made. (IRC Section 6221(b)(1)(D) and (E)) The IRS is permitted to provide for provisions to identify foreign partners for purposes of this disclosure (IRC Section 6221(b)(2)(B)).

If the partnership includes S corporation partners, the partnership making the election must also attach a disclosure of the name and taxpayer identification number of each shareholder of the S corporation. Additionally, each S Corporation K-1 is counted as if it were the partnership's own K-1 for purposes of computing the 100 K-1 limitation (IRC Section 6221(b)(2) (A)).

The Joint Committee on Taxation (JCT) published its Blue Book *(General Explanation of Legislation Enacted in 2015)* for tax laws passed in 2015, and it gives some insight into the limited extent of statutorily mandated, acceptable partners that Congress decided should enable a partnership to elect out of the new partnership audit regime when it comes into full effect for tax years beginning on or after January 1, 2018.

The "allowed partner list" at IRC Section 6221(b)(1)(C) can be expanded by the IRS in regulations (IRC Section 6221(b)(2)(C).

The JCT Blue Book, in its examples, suggests that the "allowed list" as enacted by Congress may be much more restrictive than some believed. As was noted in a Tax Analysts article in "Tax Notes Today" published on March 17, 2016 (*JCT's Surprising Interpretation of the Partnership Audit Opt-Out*, 2016 TNT 52-1), the examples suggest that many types of "disregarded entities" were not intended by Congress to be disregarded for this purpose *unless* the IRS decides, by regulation, to allow them to be disregarded.

For instance, a single member LLC (SMLLC) 100% owned by a C corporation, is discussed in the first example the Committee offers when discussing the provision allowing the IRS to expand the allowed group.

> For example, assume that a partner of a partnership is a disregarded entity such as a State-law limited liability company ("LLC") with only one member, a domestic corporation. Such guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole member, and each of them is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met.

Thus, the example indicates that, absent IRS action, the SMLLC would block the partnership's option to elect out of the new regimes. Also, even if the IRS allowed the entity, it would count as two partners toward the 100 K-1 limit (the example clearly requires counting both the SMLLC and the corporation separately in determining if the 100 K-1 limit has been met).

The report goes on to provide a similar problem for grantor trusts in a separate example.

> As another example, such guidance may provide that a partnership with a trust as a partner can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of the trustee, each person who is or is deemed to be an owner of the trust, and any other person that the Secretary determines to be necessary and appropriate, and each one of such persons is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met. Similar guidance may be provided with respect to a partnership with a partner that is a grantor trust, a former grantor trust that continues in existence for the two-year period following the death of the deemed owner, or a trust receiving property from a decedent's estate for a two-year period.

Thus, a revocable living trust that qualifies as a 100% grantor trust would also appear to fail to be an allowable partner unless the IRS regulations specifically allow such trusts to be counted.

The *Tax Notes* article points out that, while many observers had concluded that such disregarded entities should not cause problems for making the election since the law or regulations generally provide that the interest shall be treated as owned by the party holding a 100% interest in the ignored entity, the IRS had previously indicated that an SMLLC disregarded entity was a partner that blocked the application of the small partnership exception to the TEFRA partnership rules the new law replaces.

In Rev. Rul. 2004-88, the IRS held that, despite the general rule under Reg. Section 301.7701-3(a) that such an entity is disregarded as an entity separate from its owner for federal tax purposes, the regulation does not apply for this test.

> Under the facts of this ruling, although LLC is a disregarded entity for federal tax purposes, LLC is a partner of P under the law of the state in which P is organized. Similarly, although A, LLC's owner, is a partner of P for purposes of the TEFRA partnership provisions under Section 6231(a)(2)(B) because A's income tax liability is determined by taking into account indirectly the partnership items of P, A is not a partner of P under state law. Because A holds an interest in P through LLC, A is an indirect partner and LLC, the disregarded entity, is a pass-thru partner under the TEFRA partnership provisions.

Consequently, the small partnership exception does not apply to P because P has a partner that is a pass-thru partner.

As was noted in the discussion of the TEFRA rules, the IRS's position was upheld by the Ninth Circuit in the *Seaview Trading* case. Presumably, the courts would find the same position acceptable under the revised regime, especially in light of the JCT's Blue Book commentary.

Opting out is elected on Schedule B-1, Form 1065, which is attached to Form 1065. A copy is presented for you reference.

SCHEDULE B-2 (Form 1065) (December 2018) Department of the Treasury Internal Revenue Service

Election Out of the Centralized Partnership Audit Regime

► Attach to Form 1065 or Form 1066.
► Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123

Name of Partnership	**Employer Identification Number (EIN)**

Certain partnerships with 100 or fewer partners can elect out of the centralized partnership audit regime if each partner is an individual, a C corporation, a foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner. For purposes of determining whether the partnership has 100 or fewer partners, the partnership must include all shareholders of any S corporation that is a partner. By completing Part I, you are making an affirmative statement that all of the partners in the partnership are eligible partners under section 6221(b)(1)(C) and you have provided all of the information on this schedule. See the instructions, including the instructions for the treatment of real estate mortgage investment conduits (REMICs), for more details.

Part I **List of Eligible Partners**
Use the following codes under Type of Eligible Partner:
I – Individual C – Corporation E – Estate of Deceased Partner F – Eligible Foreign Entity S – S corporation

	Name of Partner	Taxpayer Identification Number (TIN)	Type of Eligible Partner (Code)
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			
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Continued on Part IV

Part II **List of S Corporation Shareholders** (For each S corporation partner, complete a separate Part II and separate Part V, if needed.)
Use the following codes under Type of Person:
I – Individual E – Estate of Deceased Shareholder T – Trust O – Other

Name of S Corporation Partner ►	TIN of Partner ►

	Name of Shareholder	Shareholder TIN	Type of Person (Code)
1			
2			
3			
4			
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8			
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11			
12			

Continued on Part V

Part III **Total Number of Schedules K-1 Required To Be Issued.** See instructions.

1	Total of Part I and all Parts IV Schedules K-1 required to be issued by the partnership	1	
2	Total of Part II and all Parts V Schedules K-1 required to be issued by any S corporation partners .	2	
3	**Total. Add line 1 and line 2**	3	

Note: If line 3 is more than 100, the partnership cannot make the election under section 6221(b).

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. Cat. No. 69658K **Schedule B-2 (Form 1065) (12-2018)**

Name of Partnership	Employer Identification Number (EIN)

Part IV Continuation of List of Eligible Partners

Use the following codes under Type of Eligible Partner:
I – Individual C – Corporation E – Estate of Deceased Partner F – Eligible Foreign Entity S – S corporation

	Name of Partner	TIN	Type of Eligible Partner (Code)
16			
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18			
19			
20			
21			
22			
23			
24			
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26			
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Name of Partnership | **Employer Identification Number (EIN)**

Part IV **Continuation of List of Eligible Partners**

Use the following codes under Type of Eligible Partner:

I – Individual C – Corporation E – Estate of Deceased Partner F – Eligible Foreign Entity S – S corporation

	Name of Partner	TIN	Type of Eligible Partner (Code)
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70			
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Name of Partnership	**Employer Identification Number (EIN)**

Part V **Continuation of List of S Corporation Shareholders** (For each S corporation partner, complete a separate Part II and separate Part V, if needed.)
Use the following codes under Type of Person:
I – Individual E – Estate of Deceased Shareholder T – Trust O – Other

Name of S Corporation Partner ▶	TIN of Partner ▶

	Name of Shareholder	Shareholder TIN	Type of Person (Code)
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14			
15			
16			
17			
18			
19			
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Name of Partnership	**Employer Identification Number (EIN)**

Part V **Continuation of List of S Corporation Shareholders** (For each S corporation partner, complete a separate Part II and separate Part V, if needed.)
Use the following codes under Type of Person:
I – Individual E – Estate of Deceased Shareholder T – Trust O – Other

Name of S Corporation Partner ▶	TIN of Partner ▶

	Name of Shareholder	Shareholder TIN	Type of Person (Code)
62			
63			
64			
65			
66			
67			
68			
69			
70			
71			
72			
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Consistent Treatment

The new rules provide, similar to the old TEFRA provision, that a partner generally must report each partnership-related item consistently with the partnership (IRC Section 6222(a)). This rule does not apply if the partner files a notice of inconsistent treatment with her return. Such a notice must also be filed if the partnership failed to file a return (IRC Section 6223(c)(1)).

Similarly, the partner can establish that she reported the item consistently with the K-1 she received even though that K-1 was not one filed by the partnership; the requirement for consistency also will not apply if the taxpayer elects to be treated as if she filed a notice of inconsistent treatment (IRC Section 6223(c)).

An IRS decision with regard to an inconsistent position where the taxpayer filed a notice of inconsistent treatment is not binding on the partnership (IRC Section 6223(b)).

In a case where the taxpayer fails to report in a manner consistent with the partnership and does not qualify for an exception noted earlier, the IRS may treat the adjustment made to restate the return on a consistent basis as a math error (IRC Section 6222(b)).

The taxpayer attaches Form 8082 to their return to disclose the inconsistent treatment. A copy of the current form was provided earlier in this unit for your reference.

Partnership Representative

The old TMP of the TEFRA system is to be replaced by a partnership representative designated by the partnership. This must be a partner or other person with a substantial presence in the United States. The representative will have sole authority to act on behalf of the partnership for purposes of the new exam rules. If no partnership representative is appointed by the partnership, the IRS has the right to appoint a partnership representative for the partnership (IRC Section 6223(a)).

The partners of the partnership will be bound by actions taken by the partnership representative under the new rules and by any final decision in a proceeding under these rules (IRC Section 6223(b)).

Adjustment of Partnership Items by the IRS

In general, for a partnership that does not elect out of the treatment under Subchapter C, the partnership pays an imputed underpayment in the adjustment year (that is, the year in which the exam adjustment is final). If the adjustments do not result in an imputed underpayment (generally meaning that they reduce taxable income), they are taken into account by the partnership in the adjustment year either as a reduction in non-separately stated income, an increase in non-separately stated loss for the year, or, for a credit, a separately stated item (IRC Section 6225(a)).

The imputed underpayment is computed by appropriately netting all partnership adjustments as defined in IRC Section 6241(2) and multiplying them by the highest tax rate in effect for the reviewed year for individuals. A decrease in an item of loss is treated as an increase in income and an increase in an item of loss is treated as a decrease in income (IRC Section 6225(b)).

If the change results in a reallocation of items between partners, the amount on which the imputed underpayment is to be computed will be calculated by ignoring the amount of decrease in the item of income or gain allocated to a partner and any increase in any item of deduction, loss, or credit. Note

that the offsetting adjustment will be included in the calculation, meaning a tax will be computed for the partner that would be expected to see an increase in tax, but no offsetting effect would be given for the reduction in expected tax for the other partner (IRC Section 6225(b)(2)).

The law allows the IRS to publish procedures under which the imputed underpayment may be modified (IRC Section 6225(c)(1)). Specifically, if any partners file amended returns that take into account their amount of adjustment and pay the tax due with such returns, their allocable amounts of the adjustment will be removed from the calculation of the imputed underpayment (IRC Section 6225(c)(2)). However, this provision only applies when a distributive share of an item is reallocated from one partner to another if all affected partners file such amended returns (IRC Section 6225(c)(2)(C)).

As an alternative to filing amended returns, a partner can "push-in" her adjustment. The partner does this by paying in the amounts that would have been paid in had all amended returns been filed. The taxpayer takes into account and adjusts all affected tax attributes, and the partner provides information in a form specified by the IRS that the agency may require. The law provides (or suggests to the IRS) that the agency could require preparation of amended returns forms that would not be filed. (IRC Section 6225(c)(2)(B))

Additionally, the procedures will provide for determining the imputed underpayment without taking into account amounts that would be allocated to a partner who would not owe tax because it is a tax-exempt entity (IRC Section 6225(c)(3)).

Similarly, the procedures will allow for adjusting the rates for any year a partnership demonstrates an allocation of ordinary income to a C corporation or, in the case of a capital gain or qualified dividend, is an individual (including an S corporation). The rate in this case will be the highest rate of tax applicable to such income for such taxpayers (IRC Section 6225(c)(4) (A)). Special provisions that require a deemed sale calculation are triggered if the adjustment affects more than one item, and those items are allocated in different ratios for different partners (IRC Section 6225(c)(4)(B)).

Any information required to be submitted by the partnership to qualify for these lower adjusted rates must be submitted within 270 days after the notice of proposed partnership adjustment (NOPPA) is mailed by the IRS unless the IRS consents to an extension of time to provide such information (IRC Section 6225(c)(6)).

If the partnership ceases to exist, the adjustment shall be taken into account by the individual partner as provided for in regulations to be issued by the IRS (IRC Section 6241(7)).

If a partnership return is filed by an entity that is later determined to not be a partnership, the new provisions apply to the entity and persons holding interests in the entity as provided for in regulations to be issued by the IRS (IRC Section 6241(8)).

Alternative to Payment of Imputed Underpayment

A partnership may elect—within 45 days of the receipt of the notice of final partnership adjustment—to use the alternative method in which the partners will be issued a statement showing their adjustments as determined by the final partnership adjustment. If this method is chosen, no imputed underpayment will be due from the partnership, but each partner will need to take the adjustment into account (IRC Section 6226(a)).

The taxpayer will be required to report any increase in tax for the reviewed year, as well as any increase in tax in subsequent years due to the adjustment of tax attributes affected by the change (IRC Section 6226(b)). The tax will be imposed in the year the statement is given to the partner.

The partner will also be responsible for any penalties that may be due (IRC Section 6226(c)(1)).

Interest will be due at the federal short-term rate plus 5 percentage points (IRC Section 6226(c)(2)). Both will be computed by referencing back to the reviewed year—that is, the year that was under examination.

If the adjustment is negative (that is, income is reduced or credits are increased), the partner computes the reduction in tax and then claims that reduction as a credit in the year the push notice is issued. Unfortunately, the credit is not refundable, nor can it be carried forward. So, if the partner does not have sufficient taxes due to other income in the year in question, some or all of the tax reduction may never be realized; however, the partner will still need to reflect any reduction in basis triggered by this change.[119]

Partnership Voluntary Request for Adjustment

A key change many advisers overlooked when these provisions were first enacted into law involved the impact on revising a previously filed partnership return. If the original due date, or in the case of a return when a request for extension of time to file was filed before the first return was filed, has not yet passed, the partnership can decide to go the route of a superseding return. That return is deemed to replace the original filing—that is, the last return filed before the actual due date becomes the original return.[120]

Due to the complications introduced by the requirements to change a partnership return once the last date to file a superseding return has passed for a partnership subject to the BBA 2015 CPAR regime, prudence suggests that an extension should be filed for all such partnerships before the original return is filed, just to allow the partnership to use the option to send updated K-1s to be reported by taxpayers in lieu of having go the AAR route.

The new law provides for a method for the partnership to voluntarily request an administrative adjustment after the original return is filed (IRC Section 6227(a)). The partnership may request the adjustment be made under the imputed underpayment rules (where the partnership pays the amounts due) or via the alternative method (IRC Section 6227(b)). However, if no imputed underpayment would result, then the partnership would be required to use the alternate method (IRC Section 6227(b)).

If the imputed underpayment method is used, the calculation is the same as if the IRS had made the adjustment, except the following modifications apply.

- No option is available for certain partners to amend their returns and remove their adjustment from the calculation.
- There is no 270-day submission period for information necessary for adjustments.

[119] A discussion of this issue and other problems raised by administrative adjustment requests is found in the article titled "Administrative adjustment requests under the BBA," by Greg Armstrong, J.D., LL.M. in the *Tax Adviser* (https://www.thetaxadviser.com/issues/2020/jun/administrative-adjustment-requests-bba.html)
[120] *Haggar v. Helvering*, 308 U.S. 389 (1940)

- There is not an IRS approval required for the adjustments (IRC Section 6227(b)(1)).

If the partnership elects to use the alternate method, the general rules of the alternate method apply except that the higher interest rate on underpayments will not apply (IRC Section 6227(a)).

Any request for an administrative adjustment must be filed by the partnership no later than three or more years after the later of:

- the date on which the partnership return for the partnership was filed or
- the last day for filing the partnership return for the applicable year, determined without regard to extensions (IRC Section 6227(c)).

Also, the request may not be made after a notice of an administrative proceeding is issued to the partnership for the year in question (IRC Section 6227(c)).

If the partnership is filing using the imputed underpayment method for its Administrative Adjustment Request (AAR), the payment must be made at the time the adjustment is requested (IRC Section 6232(a)).

If the partnership elects to pay the imputed underpayment (UI) related to an AAR, it takes the following steps, per the IRS website:

> A partnership must pay an IU and any applicable interest or penalties at the same time that the AAR is filed.
>
> - Pay by EFTPS or debit or credit card. (Direct Pay is not available for this payment.)
>   - Select BBA AAR Imputed Underpayment from the list of payment types.
>   - Apply payment to Form 1065.
> - Pay by check or money order.
> - Make payable to "United States Treasury."
>   - Include the following information: the name of the partnership, Form 1065, the tax identification number of the partnership, the tax year, and "BBA AAR Imputed Underpayment."[121]

If the partnership does not make a push out election, it can do the standard adjustments to the imputed underpayment. The partnership reports these adjustments as followed, per IRS guidance on their website:

> A partnership that does not make an AAR push out election can request certain modifications to the IU amount. Complete and attach to the AAR Form 8980, *Partnership Request for Modification of Imputed Underpayments Under IRC Section 6225(c)*, and any related forms that apply. See Publication 5346, *Instructions for Form 8980*.

[121] "File an Administrative Adjustment Request," IRS website, https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request (retrieved June 21, 2021)

> If a partnership makes an AAR push out election instead of paying an IU, any potential modifications that may have applied to the IU are disregarded.[122]

If a partnership wishes to make an AAR push out election, it takes the following steps:

> If the partnership elects AAR push out OR the AAR contains adjustments that do not result in an IU, it must include Form 8985 and Forms 8986 with the AAR submission. Forms 8986 must also be furnished to the partners on the date that the AAR is filed with the IRS. Following are the relevant forms:
>
> - AAR filing forms—Refer to instructions for Forms 1065-X or Form 8082 for details on how to elect push out on an AAR.
> - Form 8985, *Pass-Through Statement—Transmittal/Partnership Adjustment Tracking Report (Required under Sections 6226 and 6227)*—Should be included with the AAR submission.
> - Forms 8986, *Partner's Share of Adjustments(s) to Partnership-Related Items (Required Under Sections 6226 and 6227)*—Should be included with the AAR submission AND furnished to the partners.[123]

For partners receiving a Form 8986 following a push-out election, the IRS provides guidance on the IRS website. For non-pass-through partners the IRS provides the following guidance.

> Non-pass-through partners who receive a Form 8986 as a result of an AAR will:
>
> - Use Form 8978, *Partner's Additional Reporting Year Tax*, to calculate and report their tax impact of adjustments pushed out to them.
> - File Form 8978 with their income tax return that includes the date that the partnership furnished Forms 8986 to its direct partners (reporting year return).
> - The non-pass-through partner may pay in advance to stop the running of interest.
>   - Pay by EFTPS, debit or credit card, or Direct Pay (Forms 1040 only).
>   - Select Prepayment on BBA AAR/Exam Push Out as payment type.
>   - Apply payment to Forms 1040, 1120 (except 1120S), or 990T.[124]

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[122] "File an Administrative Adjustment Request," IRS website, https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request (retrieved June 21, 2021)
[123] "File an Administrative Adjustment Request," IRS website, https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request (retrieved June 21, 2021)
[124] "File an Administrative Adjustment Request," IRS website, https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request (retrieved June 21, 2021)

A pass-through partner has two choices. The partnership can opt to make its own push-out election on the adjustments that have come down to the partnership and take the following steps:

- Furnish a Form 8986 to each partner for the tax year of the pass-through partner that includes the end of the review year.
- Submit to the IRS Form 8985 and Forms 8986 by fax to 888-981-6982.[125]

In the alternative, this partnership can opt to calculate and pay the IU based on that adjustment:

- Use Form 8985, *Pass-Through —Statement Transmittal/Partnership Adjustment Tracking Report* (Required under Sections 6226 and 6227), to report the calculation and amount paid.
- Pay by EFTPS, debit or credit card. (Direct Pay is not available for this payment.)
  - Select BBA AAR Push Out (as reported on F8985) as payment type.
  - Apply payment to Forms 1041, 1065, or 1120S.
- Pay by check or money order.
  - Make payable to "United States Treasury."
  - Include the following information: the name of the pass-through partner, form number (1065, 1120S, or 1041), the tax identification number of the pass-through partner, the tax year, and "BBA AAR Push Out."
  - Complete Form 8985-V, *Tax Payment by a Pass-Through Partner*: Select "BBA AAR push out" as payment type on the form.
  - Mail check or money order with the completed Form 8985-V to: Department of the Treasury Internal Revenue Service, Ogden, UT 84201-0011
- Submit to the IRS Forms 8985 and Forms 8986, as applicable, by fax to 888-981-6982.

The IRS has begun issuing some relief in special cases that have allowed partnerships that otherwise would have been required to file an Administrative Adjustment Request to instead file simply a revised Form 1065 and give the partners revised K-1s they can use to amend their individual returns.[126] Advisers working with trusts should be on the lookout for these special rulings because there may be little time to take action to avoid having to file an Administrative Adjustment Request.

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[125] "File an Administrative Adjustment Request," IRS website, https://www.irs.gov/businesses/partnerships/file-an-administrative-adjustment-request (retrieved June 21, 2021)

[126] See Revenue Procedure 2021-50 for an example where the IRS allowed a short period of time (just over a month after releasing guidance on the timing of reporting PPP loan forgiveness) to file an amended return rather than AAR.

IRS Notice of Proceeding

The IRS must mail to the partnership and the partnership representative notice of any:

- administrative proceeding initiated at the partnership level,
- proposed adjustment resulting from such proceedings, and
- final partnership adjustment resulting from the proceeding (IRC Section 6231(a)).

A notice of final partnership adjustment must be mailed within 270 days of the issuance of the proposed adjustment. The 270-day rule also applies to a situation where the partnership makes a voluntary request for an administrative adjustment outside of an examination (IRC Section 6231(a)).

Absent a showing of fraud, the IRS may not issue a second notice of final partnership adjustment after the taxpayer has filed a court petition to challenge the original notice (IRC Section 6231(b)).

With the consent of the partnership, the IRS may rescind a final notice of partnership adjustment. Once the notice has been withdrawn, the partnership can no longer file a petition in court with regard to the withdrawn adjustment (IRC Section 6231(c)).

Effective Date

The new rules apply to returns filed for years beginning after December 31, 2017. See also below our discussion of T.D. 9844 and its provisions. The introduction to T.D. 9844 provides: "These final regulations affect partnerships for taxable years beginning after December 31, 2017, and ending after August 12, 2018, as well as partnerships that make the election to apply the centralized partnership audit regime to partnership taxable years beginning on or after November 2, 2015, and before January 1, 2018."

FINAL REGULATIONS

The IRS has partially completed the process of issuing final regulations for the various CPAR provisions.

Opting Out of CPAR (Reg. Section 301.6621(b)-1)

Some partnerships will be authorized under the centralized partnership audit regime (CPAR) to elect to opt out of the centralized exams if they meet certain requirements. Reg. 301.6221(b)-1 (TD 9829) provides the details for which partnerships can opt out and how they will go about doing so.

The CPAR, which takes effect for returns filed for years beginning on or after January 1, 2018, represents a major change in how partnership returns will be examined. By default, a tax will be determined and assessed at the partnership level (IRC Section 6221(a)). In the alternative, a partnership subject to the CPAR can elect to push out the adjustments to the partners in the year under review (IRC Section 6226).

Congress provided an option for some partnerships to elect out of the CPAR and instead be taxed under traditional partnership exam rules (what were the small partnership examinations under the now-repealed TEFRA rules). Note that the election is an annual election, so electing to opt out of

the CPAR for 2018 does not require the partnership to opt out for 2019. Nor will the partnership be opted out for 2019 unless the partnership both qualifies to make the election and files a timely election.

To be eligible to elect out of the CPAR under IRC Section 6221(b) for a tax year, a partnership cannot have any partners other than eligible partners as provided at IRC Section 6221(b)(1)(C) as well as any additional types of partners the IRS may designate as eligible under the authority granted to the agency in IRC Section 6221(b)(2)(C).

The IRS has not exercised its authority to expand the list of eligible partners beyond those provided in the statute. Thus, per Reg. Section 301.6221(b)-1(b)(3), the following are the eligible partners:

- An individual
- A C corporation
- A foreign entity would be treated as a C corporation if it were a domestic entity
- An S corporation
- An estate of a deceased partner

The regulations provide specifically that the following partners are *not* eligible partners. If any partners of the partnership are one of these entity types, the partnership will not be eligible to opt out of CPR:

- A partnership
- A trust
- A foreign entity that would not be taxed as a C corporation if it were a domestic entity
- A disregarded entity described in Section 301.7701-2(c)(2)(i)
- An estate of an individual other than a deceased partner
- Any person who holds an interest in the partnership on behalf of another person (Reg. Section 301.6221(b)-1(b)(3)(ii))

However, an S corporation remains an eligible partner even if one of its shareholders would not itself be an eligible partner (Reg. Section 301.6221(b)-1(b)(3)(i)). So, any of the entities just listed that would be an eligible S partner (e.g., a revocable living trust treated as owned entirely by a U.S. citizen) could indirectly hold an interest via an S corporation without having an effect on the ability of the partnership to election to opt out of CPAR.

The IRS provides the following examples of applying the eligible partner rules:

EXAMPLE 1

During the 2020 taxable year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, D, is a partnership. Because D is a partnership, D is not an

eligible partner under paragraph (b)(3)(i) of this section. Accordingly, Partnership is not an eligible partnership under paragraph (b)(1) of this section and, therefore, cannot make the election under paragraph (a) of this section for its 2020 taxable year.

EXAMPLE 2

During its 2020 taxable year, Partnership has four equal partners. Two partners are individuals. One partner is a C corporation. The fourth partner, S, is an S corporation. S has ten shareholders. One of S's shareholders is a disregarded entity, and one is a qualified small business trust. S is an eligible partner under paragraph (b)(3)(i) of this section even though S's shareholders would not be considered eligible partners if those shareholders held direct interests in Partnership. See paragraph (b)(3)(i) of this section. Accordingly, Partnership meets the requirements under this paragraph (b)(3) for its 2020 taxable year.

EXAMPLE 3

During its 2020 taxable year, Partnership has two equal partners, A, an individual, and C, a disregarded entity, wholly owned by B, an individual. C is not an eligible partner under paragraph (b)(3)(i) of this section. Accordingly, Partnership is not an eligible partnership under paragraph (b)(1) of this section and, therefore, is ineligible to make the election under paragraph (a) of this section for its 2020 taxable year.

Aside from not having an ineligible partner, a partnership must meet certain other requirements to opt out of CPAR. Specifically, the following must both be true.

- The partnership has 100 or fewer partners.
- Each K-1 the partnership is required to furnish for the partnership taxable year is furnished to a partner who was an eligible partner for the partnership's entire taxable year (Reg. Section 301.6221(b)-1(b)(1)).

A partnership is considered to have 100 or fewer partners if it is required to furnish 100 or fewer K-1s for the taxable year. However, if any of the partners are S corporations, the partnership must add to the K-1s it is required to issue for the year (including those to S corporation partners) the number of K-1s issued by the S corporation(s) for the taxable year of the S corporation ending with or within the partnership's taxable year.

The partnership does not need to "look through" a decedent's estate and count any K-1s issued by the estate for the 100 K-1 test (Reg. Section 301.6221(b)-1(b)(2), Example 5). If a spouse has a community property interest in a partnership interest held by her spouse, only one K-1 is required to be issued, and therefore, the couple counts as only a single partner for the 100 K-1 test (Reg. Section 301.6221(b)- 1(b)(2), Example 2). However, if each spouse holds an interest in the partnership other than a community property interest, two K-1s are required to be issued to the couple, and that counts as two K-1s for purposes of the 100 K-1 test (Reg. Section 301.6221(b)-1(b)(2), Example 1).

Reg. Section 301.6221(b)-1(c) gives information on how the election is to be made. The regulation provides generally that "[a]n election under this section must be made on the eligible partnership's timely filed return, including extensions, for the taxable year to which the election applies and include all information required by the Internal Revenue Service (IRS) in forms, instructions, or other guidance" (Reg. Section 301.6221(b)-1(c)(1)). An election, once made, cannot be revoked without the permission of the IRS (Reg. Section 301.6221(b)-1(c) (1)).

The partnership must disclose the following information about each partner to the IRS for the year in which it makes the election:

- Each partner's name
- Each partner's correct U.S. taxpayer identification number (TIN) (or alternative form of identification required by forms, instructions, or other guidance)
- Each partner's federal tax classification
- An affirmative statement that the partner is an eligible partner under paragraph (b)(3)(i) of this regulation
- Any other information required by the IRS in forms, instructions, or other guidance (Reg. Section 301.6221(b)-1(c)(2))

If any partner is an S corporation, the partnership must also disclose the following information about each shareholder of the S corporation who was a shareholder at any time during the taxable year of the S corporation ending with or within the partnership's taxable year:

- Each shareholder's name
- Each shareholder's correct TIN (or alternative form of identification as prescribed by forms, instructions, or other guidance)
- Each shareholder's federal tax classification
- Any other information required by the IRS in forms, instructions, or other guidance (Reg. Section 301.6221(b)-1(c)(2))

A partnership that makes this election must notify each partner within 30 days of making the election. However, the form and manner of the notification is to be determined by the partnership (Reg. Section 301.6221(b)-1(c)(3)). In the preamble, the IRS also noted that while the partnership must send a notice to any S corporation partner(s), the S corporation(s) will determine how (or presumably if) it will notify any shareholders of the election.

Any election made by a partnership only applies to that partnership, and does not apply to any partnership of which the electing partnership may be a partner (Reg. Section 301.6221(b)1(d)).

The partnership and the partners are bound by the election unless and until the IRS determines an election is invalid (Reg. Section 301.6221(b)-1(d)(1)). If the IRS determines that an election is not valid, it will notify the partnership in writing and the partnership will be subject to a standard CPAR examination for the year in question (Reg. Section 301.6221(b)-1(d) (1)).

The election is made on Form 1065, Schedule B. Note the information to be provided on the draft version of the form. Similarly, the fact that there are only 98 spaces for S corporation shareholders points out that this is the absolute maximum number of shareholders an S corporation partner could have for a partnership to be eligible to opt out.

First, there must be at least one other owner besides the S corporation or we'd not have a partnership, leaving only 99 available K-1s. Second, the K-1 issued to the S corporation itself counts

as one K-1, now leaving only 98 available K-1s for S corporation shareholders, assuming there is only one other partner (and that partner is not itself an S corporation).

Partnership Representative (Regs. Sections 301.6223-1 & 301.6223-2)

Under CPAR, the partnership representative fills a role that is similar to that of the TMP under the TEFRA regime—but there are significant differences.

Definition of the Partnership Representative

Under Reg. Section 301.6223-1(a), the basic provisions governing the partnership representative are outlined. Every partnership subject to CPAR must designate a partnership representative and the partnership can only have a single partnership representative at a time.

Once appointed, the partnership representative will remain in that position until:

- a valid resignation takes place under the regulations;
- a valid revocation takes place under the regulations; or
- the IRS makes a determination that the designation is no longer in effect.[127]

The representative must update his contact information as required by forms, instructions, or other guidance the IRS may issue.

Eligibility to Serve as Partnership Representative

Any person or entity (not just a partner) who meets the requirements may serve as a partnership representative.[128] The final regulations clarified that the partnership can appoint itself as its own partnership representative.[129]

To serve as a partnership representative, the individual must have a substantial presence in the United States. A substantial presence exists if:

- The person makes themselves available to meet in person with the IRS in the United States at a reasonable time and place as determined by the IRS in accordance with Section 301.7605-1; and
- The person has a United States taxpayer identification number, a street address that is in the United States and a telephone number with a United States area code.[130]

In addition to an individual, the partnership can designate an entity to be its partnership representative. In this case, there must be appointed a "designated individual." The designated

[127] Reg. Section 301.6223-1(a)

[128] Reg. Section 301.6223-1(b)

[129] Reg. Section 301.6223-1(b)(1)

[130] Reg. Section 301.6223-1(b)(1)

individual must be an individual who meets the requirements to have been the partnership representative.[131]

Although the proposed regulations contained a provision that treated the individual as not eligible to be a partnership representative if the representative lacked the capacity to act, those provisions were removed from the final regulations.

EXAMPLE 1

Reg. 301.6223-1(b)(4)

Partnership designates PR as its partnership representative for its 2018 tax year on its timely filed 2018 partnership return. The IRS initiates an administrative proceeding with respect to Partnership's 2018 tax year. PR has a United States taxpayer identification number, a United States street address, and a phone number with a United States area code. The IRS contacts PR and requests an in-person meeting with respect to the administrative proceeding. PR works with the IRS and agrees to meet. PR has substantial presence in the United States because she meets all the requirements under paragraph (b)(2) of this section.

EXAMPLE 2

Reg. 301.6223-1(b)(4)

The facts are the same as in Example 1 of this paragraph (b)(4), except that PR is an entity and Partnership appointed DI, a designated individual to act on behalf of PR for its 2018 tax year on its timely filed 2018 partnership return. DI has a United States taxpayer identification number and a phone number with a United States area code. However, the address provided for DI is not a United States address. Accordingly, PR is not an eligible partnership representative because PR is an entity and DI does not satisfy the requirements of paragraph (b)(3)(i) of this section.

Although DI does not have substantial presence in the United States under paragraph (b)(2) of this section and therefore PR is not an eligible partnership representative, until there is a resignation or revocation under paragraph (d) or (e) of this section or until the IRS determines the partnership representative designation is no longer in effect under paragraph (f) of this section, the designation of PR as the partnership representative remains in effect in accordance with paragraph (a) of this section, and Partnership and all its partners are bound by the actions of PR as the partnership representative.

EXAMPLE 3

Reg. 301.6223-1(b)(4)

The facts are the same as in Example 1 of this paragraph (b)(4), except PR works in a foreign country and spends the majority of her time there. Unless PR otherwise fails to meet one of the requirements under paragraph (b)(2) of this section, PR has substantial presence in the United States. However, even if PR fails to meet one of the requirements under paragraph (b)(2) of this section, until there is a resignation or revocation under paragraph (d) or (e) of this section or until the IRS determines the partnership representative designation is no longer in effect under paragraph (f) of this section, the designation of PR as the partnership representative remains in effect in accordance with paragraph (a) of this section, and Partnership and all its partners are bound by the actions of PR as the partnership representative.

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[131] Reg. Section 301.6223-1(b)(2)

Designation of the Partnership Representative

A separate designation must be made each year for the partnership representative and the designation is only effective for that year.[132] The actual designation process is defined at Reg. Section 301.6223-1(c)(2).

> Except in the case of a designation of a partnership representative (and the appointment of the designated individual, if applicable) after an event described in paragraph (d) of this section (regarding resignation), paragraph (e) of this section (regarding revocation by the partnership), or paragraph (f) of this section (regarding designation made by the IRS), or except as prescribed in forms, instructions, and other guidance, designation of a partnership representative (and the appointment of the designated individual, if applicable) must be made on the partnership return for the partnership taxable year to which the designation relates and must include all of the information required by forms, instructions, and other guidance, including information about the designated individual if paragraph (b)(3) of this section applies. The designation of the partnership representative (and the appointment of the designated individual, if applicable) is effective on the date that the partnership return is filed.

The IRS provides the following example of designating a partnership representative in Reg. Section 301.6223-1(c)(3).

EXAMPLE

Reg. Section 301.6223-1(c)(3)

Partnership properly designates PR1 as its partnership representative for taxable year 2018 on its 2018 partnership return. Partnership designates PR2 as its partnership representative for taxable year 2021 on its 2021 partnership return. In 2022, the IRS mails Partnership a notice of administrative proceeding under Section 6231(a)(1) with respect to Partnership's 2018 taxable year. PR1 is the partnership representative for the 2018 partnership taxable year, notwithstanding the designation of PR2 as partnership representative for the 2021 partnership taxable year.

The designation of the partnership representative is made near the bottom of page 3 of Form 1065, as part of Schedule B.

Designation of Partnership Representative (see instructions)
Enter below the information for the partnership representative (PR) for the tax year covered by this return.

Name of PR ▶		U.S. taxpayer identification number of PR ▶	
U.S. address of PR ▶		U.S. phone number of PR ▶	
If the PR is an entity, name of the designated individual for the PR ▶		U.S. taxpayer identification number of the designated individual ▶	
U.S. address of designated individual ▶		U.S. phone number of designated individual ▶	

[132] Reg. Section 301.6223-1(c)(1)

Resignation of the Partnership Representative

A partnership representative may resign his position by following the provisions in Reg. Section 301.6223-1(d) to notify the partnership and the IRS. The notification to the IRS is to be made in accordance with forms and instructions to be provided by the IRS. Unlike what the IRS had provided in the proposed regulations, the final regulations bar the partnership representative from designating a successor partnership representative. The resignation takes effect on the date the IRS receives the notice.[133] In the proposed regulations, the resignation would not have taken effect for 30 days.

As of the date the IRS receives the notice (referred to as the effective date):

1. The resigning partnership representative (and designated individual, if applicable) may not take any action on behalf of the partnership with respect to the partnership taxable year affected by the resignation;

2. The partnership representative designation is no longer in effect with respect to the partnership taxable year affected by the resignation;

3. In the case of a resigning entity partnership representative, the appointment of the designated individual is no longer in effect with respect to the partnership taxable year affected by the resignation; and

4. In the case of a resigning designated individual, the designation of the entity partnership representative is no longer in effect with respect to the partnership taxable year affected by the resignation.[134]

The IRS will notify the partnership within 30 days of the receipt of a resignation by the partnership representative.

The IRS allows the resignation to coincide with the filing of an Administrative Adjustment Request (AAR), upon receipt of a notice of a notice of administrative proceeding for the CPAR audit, or at other times the IRS may designate.[135]

Revocation of a Partnership Representative

The partnership itself can remove a partnership representative by following the procedures found in Reg. Section 301.6223-1(e). The partnership must submit the revocation as provided for by the IRS in forms and instructions and must designate a successor partnership representative at the same time or, if the partnership revokes the designated individual, must designate a new designated individual. The revocation is effective upon IRS receipt of the notice.[136]

Within 30 days of receipt of the revocation, the IRS will notify the partnership and the representative or designated individual whose status is being revoked, and the newly designated partnership representative.[137]

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[133] Reg. Section 301.6223-1(d)(1)

[134] Reg. Section 301.6223-1(d)(3)

[135] Reg. Section 301.6223-1(d)(2)

[136] Reg. Section 301.6223-1(e)(1)

[137] Reg. Section 301.6223-1(e)(1)

As of the effective date of the notification:

1. The revoked partnership representative (and designated individual, if applicable) may not take any action on behalf of the partnership with respect to the partnership taxable year affected by the revocation;

2. The designation of the revoked partnership representative is no longer in effect, and the successor partnership representative designation (and designated individual appointment, if applicable) is in effect with respect to the partnership taxable year affected by the revocation;

3. In the case of a revoked entity partnership representative, the appointment of the designated individual is no longer in effect with respect to the partnership taxable year affected by the revocation; and

4. In the case of a revoked designated individual where the designation of the entity partnership representative has not been revoked, the revoked designated individual may not take any action on behalf of the partnership with respect to the partnership taxable year affected by the revocation, the appointment of the revoked designated individual is no longer in effect, and the appointment of the successor designated individual is in effect.[138]

More detailed rules on timing are provided for revocation than for resignation, but again the regulations provide for revocation either following the issuance of a selection for exam, a notice of administrative proceeding (NAP) or with an AAR. The regulations also provide that the IRS may provide other times during which the agency will allow a revocation to be made.[139]

If the partnership is submitting an AAR, the designation may be revoked at that time. However, an AAR may not be submitted solely to revoke the designation of a partnership representative (Reg. Section 301.6223-1(e)(2)(ii)).

The IRS appears to be attempting to reduce the correspondence the agency will receive about either resignations or revocations by limiting the times when the actions may be taken. For partnerships, this creates some problems, since the partnership would likely become aware the representative no longer is willing to serve or the partnership may not wish the representative to serve at a time other than one when the action can be taken. The IRS received comments to this effect, but determined that since the partnership representative is not needed until either an exam is underway or an AAR is filed, allowing for partnerships to file changes before either event would result in having to process a number of change requests for representatives that are never needed.

The partnership, representative, or both will need to ensure the proper actions are taken when the opportunity first arises to make the submission.

Revocation has one additional problem—who can sign the revocation on behalf of the partnership? Under the general rules applicable to CPAR exams, only the partnership representative may act on behalf of the partnership, but presumably a partnership is revoking the status because the partnership representative is not willing to resign. Reg. Section 301.6223-1(e)(3) provides the rules for who may sign a designation.

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[138] Reg. Section 301.6223-1(e)(3)

[139] Reg. Section 301.6223-1(e)(2)(i)

The revocation must be signed by "a person who was a partner at any time during the partnership taxable year to which the revocation relates or as provided in forms, instructions, and other guidance prescribed by the IRS."[140]

A valid revocation must contain each of the following elements:

1. A certification under penalties of perjury that the person signing the notification is a partner described in paragraph (e)(4) of this section authorized by the partnership to revoke the designation of the partnership representative (or appointment of the designated individual, if applicable).

2. A statement that the person signing the notification is revoking the designation of the partnership representative (or appointment of the designated individual, if applicable);

3. A designation of a successor partnership representative (and appointment of a designated individual, if applicable) in accordance with this section and forms, instructions, and other guidance prescribed by the IRS; and

4. In the case of a revocation of an appointment of a designated individual, appointment of a successor designated individual in accordance with this section and forms, instructions, and other guidance prescribed by the IRS.141

If the IRS receives more than one revocation of designation of a partnership representative within a 90-day period, the IRS may determine that no designation is in effect.[142] Not surprisingly, Reg. Section 301.6223-1(f)(4) provides that in a case of multiple revocations, the IRS will appoint the representative and will not give the partnership the right to appoint one. As well, the partnership also cannot revoke an IRS designation without permission, so the partnership will be stuck with the choice of the IRS.

The IRS provides two examples of the revocation process in Reg. Section 301.6223-1(d)(8), both of which deal with invalid revocations.

EXAMPLE 1

Reg. 301.6223-1(d)(8)

Partnership properly designates PR, an individual, as partnership representative for its 2018 taxable year on its timely filed 2018 partnership return. In 2020, Partnership mails written notification to the IRS to revoke designation of PR as its partnership representative for Partnership's 2018 taxable year. The revocation is not made in connection with an AAR for Partnership's 2018 taxable year, and the IRS has not mailed Partnership a notice of selection for examination or a NAP under Section

6231(a)(1) with respect to Partnership's 2018 taxable year. Because the revocation was not made when permitted under paragraph (e)(2) of this section, the revocation is not effective and B remains the partnership representative for Partnership's 2018 taxable year unless and until B's status as partnership representative is properly revoked under paragraph (e) of this section or terminated in accordance with paragraph (d) (regarding resignation) or (f) (regarding IRS designation) of this section.

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[140] Reg. Section 301.6223-1(e)(4)

[141] Reg. Section 301.6223-1(e)(4)

[142] Reg. Section 301.6223-1(e)(7)

EXAMPLE 2

Reg. 301.6223-1(d)(8)

During an administrative proceeding with respect to Partnership's 2018 taxable year, Partnership provides the IRS with written notification to revoke its designation of PR, an individual, as its partnership representative for the 2018 taxable year. The written notification does not include a designation of a new partnership representative for Partnership's 2018 taxable year. Because the revocation does not include a designation of a new partnership representative as required under paragraph (e)(1) of this section, the revocation is not effective and PR remains the partnership representative for Partnership's 2018 taxable year unless and until B's status as partnership representative is properly revoked under paragraph (e) of this section or terminated in accordance with paragraph (d) (regarding resignation) or (f) (regarding IRS designation) of this section.

Designation of the Partnership Representative by the IRS

The law provides that if no partnership representative is properly designated by the partnership, the IRS is given the power to select the partnership representative (IRC Section 6223(a)).

The IRS must first determine that no partnership representative designation is in effect for the year. If this is what the IRS determines:

> The IRS will notify the partnership that a partnership representative designation is not in effect. The IRS will also notify the most recent partnership representative for the partnership taxable year, except as described in paragraph (f)(2)(iii)[143] of this section. In the case of an entity partnership representative, the notification will be sent to the entity partnership representative, to the attention of the designated individual. The determination that a designation is not in effect is effective on the date the IRS mails the notification.[144]

Except in a case where the IRS has received multiple revocations within a 90-day period as described earlier, the IRS gives the partnership 30 days to designate a successor before the agency does so. If the partnership fails to make the designation in accordance with the conditions provided in Reg. Section 301.6223-1(f)(3), the IRS will appoint a representative in accordance with the guidance found in Reg. Section 301.6223-1(f)(5).[145]

The partnership that has been notified of the opportunity to designate a partnership representative may do so during the 30-day period by complying with the following conditions:

> Designation of a partnership representative (and appointment of a designated individual, if applicable) by the partnership during the 30-day period described in paragraph (f)(1) of this section must be made in accordance with forms, instructions, and other guidance prescribed by the IRS. If the partnership fails to provide all information required by forms,instructions, and other guidance, the

[143] The partnership had failed to appoint an eligible partnership representative, likely by failing to include the designation on the tax return for the year in question.

[144] Reg. Section 301.6223-1(f)(1)

[145] Reg. Section 301.6223-1(f)(1)

> partnership will have failed to make a designation (and appointment, if applicable). If the partnership does not fully comply with the requirement of this paragraph (f)(3) within the 30-day period described in paragraph (f)(1) of this section, the IRS will designate a partnership representative (and appoint a designated individual, if applicable).[146]

Reg. Section 301.6223-1(f)(2) provides a list of situations in which the IRS may, *but is not required to*, determine that no partnership representative designation is in effect.

- The partnership representative or the designated individual does not have substantial presence in the United States (as described in Reg. Section 301.6223-1(b)(2));
- The partnership failed to appoint a designated individual if an entity is appointed as the designated representative (as described in Reg. Section 301.6223-1(b)(3));
- The partnership failed to make a valid designation of a designated representative;
- The partnership representative or designated individual resigns;
- The partnership has made multiple designations within 90 days; or
- The partnership representative designation is no longer in effect as described in other published guidance.

The final regulations added the provision that the IRS is not required to find that no designation is in effect. That gives the IRS the discretion to continue to work with the representative the partnership designated even if it is later discovered that the representative did not meet the requirements to be a partnership representative, as well to waive the issue that multiple designations were made during a 90-day period.

As well, the regulations make clear the IRS is not required to search for the factors that allow the agency to determine no partnership representative designation is in effect, nor does the fact that the IRS is aware of the facts require the agency to determine that no designation is in effect.[147]

Thus, a disgruntled partner will apparently not be able to challenge the results of the partnership examination by arguing that the IRS failed to notice that there was no valid partnership representative, at least absent a showing that the IRS abused its discretion by failing to act to force the designation of a new representative.

If the partnership has failed to designate a representative during the 30-day period, or the IRS has declared there is no partnership representative due to multiple revocations within 30 days, the IRS will designate a partnership representative.

If the IRS designates a partnership representative, the regulations describe the notification process as follows:

> The IRS designates a partnership representative under this paragraph (f)(5) by notifying the partnership of the name, address, and telephone number of the new partnership representative. If the IRS designates an entity partnership representative,

[146] Reg. Section 301.6223-1(f)(3)

[147] Reg. Section 301.6223-1(f)(3)

> the IRS will also appoint a designated individual to act on behalf of the entity partnership representative. The designation of a partnership representative (and appointment of a designated individual, if applicable) by the IRS is effective on the date on which the IRS mails the notification of the designation (and appointment, if applicable) to the partnership. The IRS will also mail a copy of the notification of the designation (and appointment, if applicable) to the new partnership representative (through the new designated individual, if applicable) that has been designated (and appointed, if applicable) by the IRS under this section.[148]

Reg. Section 301.6223-1(f)(5)(ii) provides information on how the IRS is to go about designating a partnership representative in this case. The regulation notes that the IRS may appoint any person to be the partnership representative.

The regulation notes that the key guiding principal for the IRS in selecting a partnership representative is the following:

> Although the IRS may designate any person to be the partnership representative, a principal consideration in determining whom to designate as a partnership representative is whether there is a reviewed year partner that is eligible to serve as the partnership representative in accordance with paragraph (b)(1) of this section or whether there is a partner at the time the partnership representative designation is made that is eligible to serve as the partnership representative.[149]

The regulation provides other factors that will ordinarily be considered by the IRS in determining the new partnership representative the IRS will appoint:

- The views of the partners having a majority interest in the partnership regarding the designation;
- The general knowledge of the person in tax matters and the administrative operation of the partnership;
- The person's access to the books and records of the partnership;
- Whether the person is a United States person (within the meaning of IRC Section 7701(a)(30)); and
- The profits interest of the partner in the case of a partner.[150]

The final regulations addressed a concern some had expressed—since the IRS has the power under the law to appoint anyone as a partnership representative, would the IRS use that power to appoint an IRS employee as representative, especially in cases of the multiple revocation rule where the partnership would need IRS permission to change the representative?

The IRS provided that an IRS employee, agent, or contractor will not be appointed as the partnership representative "unless that employee, agent, or contractor was a reviewed year partner or is currently a partner in the partnership."[151]

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[148] Reg. Section 301.6223-1(f)(5)(i)

[149] Reg. Section 301.6223-1(f)(5)(ii)

[150] Reg. Section 301.6223-1(f)(5)(ii)

[151] Reg. Section 301.6223-1(f)(5)(iii)

The IRS provides four examples of situations involving the IRS designation of a representative at Reg. Section 301.6223-1(f)(6).

EXAMPLE 1

Reg. Section 301.6223-1(f)(6)

The IRS determines that Partnership has designated a partnership representative that does not have substantial presence in the United States as defined in paragraph (b)(2) of this section. The IRS may, but is not required to, determine that the designation is not in effect and designate a new partnership representative after following the procedures in this paragraph (f).

EXAMPLE 2

Reg. Section 301.6223-1(f)(6)

Partnership designates as its partnership representative a corporation but fails to appoint a designated individual to act on behalf of the corporation as required under paragraph (b)(3) of this section. The IRS may, but is not required to, determine that the partnership representative designation is not in effect and may designate a new partnership representative after following the procedures in this paragraph (f).

EXAMPLE 3

Reg. Section 301.6223-1(f)(6)

The partnership representative resigns pursuant to paragraph (d) of this section. The IRS mails Partnership a notification informing Partnership that no designation is in effect and that the IRS plans to designate a new partnership representative. Partnership fails to respond within 30 days of the date the IRS mails the notification. The IRS must designate a partnership representative pursuant to this paragraph (f).

EXAMPLE 4

Reg. Section 301.6223-1(f)(6)

Partnership designated on its partnership return a partnership representative, PR1. After Partnership received a NAP, Partnership submits to the IRS the form described in paragraph (e)(4) of this section requesting the revocation of PR1's designation as partnership representative and designating PR2 as the partnership representative. Sixty days later, Partnership signs and submits a form described in paragraph (e)(4) of this section requesting the revocation of PR2's designation as partnership representative and designating PR3 as the partnership representative. The IRS accepts the revocation of PR2 and designation of PR3 as valid and effective upon receipt pursuant to paragraph (e)(3) of this section. However, because PR2's revocation was within 90 days of PR1's revocation, the IRS may determine within 90 days of IRS's receipt of PR2's revocation, pursuant to paragraphs (e)(7) and (f)(2) of this section, that there is no designation in effect due to multiple revocations. The IRS may then designate a new partnership representative pursuant to this paragraph (f) without allowing Partnership an opportunity to designate a partnership representative within the 30-day period described in paragraph (f)(1) of this section.

Binding Effect of Actions of Partnership Representative

Reg. Section 301.6223-2 outlines the powers of the partnership representative. The CPAR exam regime gives the partnership representative complete powers to represent the partnership in most circumstances, and the actions of the partnership representative are binding on the partnership and the partners for any matter covered by the CPAR exam regime (Reg. Section 301.6223-2(a)).

Reg. Section 301.6223-2(a) provides:

> The actions of the partnership and the partnership representative taken under subchapter C of chapter 63 of the Internal Revenue Code (subchapter C of chapter 63) and any final decision in a proceeding brought under subchapter C of chapter 63 with respect to the partnership bind the partnership, all partners of the partnership (including partnership- partners as defined in Section 301.6241-1(a)(7) that have a valid election under Section 6221(b) in effect for any taxable year that ends with or within the taxable year of the partnership), and any other person whose tax liability is determined in whole or in part by taking into account directly or indirectly adjustments determined under subchapter C of chapter 63 (for example, indirect partners as defined in Section 301.6241-1(a)(4)). For instance, a settlement agreement entered into by the partnership representative on behalf of the partnership, a notice of final partnership adjustment (FPA) with respect to the partnership that is not contested by the partnership, or the final decision of a court with respect to the partnership if the FPA is contested, binds all persons described in the preceding sentence.

Even if the representative designated is terminated, any actions taken before the termination date remain binding on the partnership. The regulation gives, as an example, a representative who consented to extend the statute of limitations for assessments pursuant to IRC Section 6235(b). Even if the partners, perhaps upset over that extension, were to move to terminate the partnership representative's status and appoint a new one, the extension would remain valid.[152]

If the IRS, after issuing a notice of administrative proceeding (NAP) to the partnership, withdraws the NAP prior to commencing a CPAR examination, the regulations provide:

> If the IRS issues a notice of administrative proceeding (NAP) under Section 6231(a)(1) and subsequently withdraws such NAP pursuant to Section 301.6231-1(f), any actions taken by a partnership representative (or successor partnership representative after a change to the partnership representative that occurred after the issuance of the NAP and before the NAP was withdrawn) are binding as described in paragraph (a) of this section even though the NAP has been withdrawn and has no effect for purposes of subchapter C of chapter 63.[153]

The regulation notes that the power to act on behalf of the partnership rests exclusively with the partnership representative. If an entity is appointed as the partnership representative, the power to act effectively resides with the designated individual.

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[152] Reg. Section 301.6223-2(b)

[153] Reg. Section 301.6223-2(c)

The regulations provide specifically:

> Except for a partner that is the partnership representative or the designated individual, no partner, or any other person, may participate in an administrative proceeding without the permission of the IRS. *The failure of the partnership representative to follow any state law, partnership agreement, or other document or agreement has no effect on the authority of the partnership representative or the designated individual as described in Section 6223, Section 301.6223-1, and this section.*[154]

That last sentence is important for all parties to understand—you can't directly limit the authority of the partnership representative via the partnership agreement. At best, it would appear you could only hold the representative liable for taking actions with regard to the exam that go beyond what the partners had agreed the representative could do.

However, the partnership representative can still appoint a third party (such as a CPA or attorney) to represent the partnership in the examination via properly executed power of attorney.[155]

If the partnership is required to appoint a designated individual (that is, it appointed an entity as the partnership representative), then that individual is the party with the power to bind the partnership.[156]

The IRS provides the following five examples of the actions of a partnership representative:

EXAMPLE 1

Reg. 301.6223-2(e)

Partnership designates a partnership representative, PR, on its timely filed partnership return for 2020. PR is a partner in Partnership. The partnership agreement for Partnership includes a clause that requires PR to consult with an identified management group of partners in Partnership before taking any action with respect to an administrative proceeding before the IRS. The IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year. During the course of the administrative proceeding, PR consents to an extension of the period of limitations on making adjustments under Section 6235(b) allowing additional time for the IRS to mail an FPA. PR failed to consult with the management group of partners prior to agreeing to this extension of time. PR's consent provided to the IRS to extend the time period is valid and binding on Partnership because, pursuant to Section 6223, PR, as the designated partnership representative, has authority to bind Partnership and all its partners.

EXAMPLE 2

Reg. 301.6223-2(e)

Partnership designates a partnership representative, PR, on its timely filed partnership return for 2020. PR is not a partner in Partnership. During an administrative proceeding with respect to Partnership's 2020 taxable year, PR agrees to certain partnership adjustments and within 45 days after the issuance of the FPA elects the alternative to payment of the imputed underpayment under Section 6226. Certain partners in Partnership challenge the actions taken by PR during the administrative proceeding and the validity of the Section 6226 statements furnished to those partners, alleging that PR was never authorized to act on behalf

[154] Reg. Section 301.6223-2(d)(1)

[155] Reg. Section 301.6223-2(d)(1)

[156] Reg. Section 301.6223-2(d)(ii)

of Partnership under state law or the partnership agreement. Because PR was designated by Partnership as the partnership representative under Section 6223 and this section, PR was authorized to act on behalf of Partnership for all purposes under subchapter C of chapter 63, and the IRS may rely on that designation as conclusive evidence of PR's authority to act on behalf of Partnership.

EXAMPLE 3

Reg. 301.6223-2(e)

Partnership designates an entity partnership representative, EPR, and appoints an individual, A, as the designated individual on its timely filed partnership return for 2020. EPR is a C corporation. A is unaffiliated with EPR and is not an officer, director, or employee of EPR. During an administrative proceeding with respect to Partnership's 2020 taxable year, A, acting for EPR, agrees to an extension of the period of limitations on making adjustments under Section 6235(b) from March 15, 2024 to December 31, 2024. The IRS mails an FPA with respect to the 2020 partnership taxable year on December 13, 2024, before expiration of the extended period of limitations on making adjustments as agreed to by EPR, but after the expiration of the unextended period of limitations on making adjustments. Partnership challenges the FPA as untimely, alleging that A was not authorized under state law to act on behalf of EPR and thus the extension agreement was invalid. Because A was appointed by the partnership as the designated individual to act on behalf of EPR, A was authorized to act on behalf of EPR for all purposes under subchapter C of chapter 63, and the IRS may rely on that appointment as conclusive evidence of A's authority to act on behalf of EPR and Partnership.

EXAMPLE 4

Reg. 301.6223-2(e)

The partnership representative, PR, consents to an extension of the period of limitations on making adjustments under Section 6235(b) and Section 301.6235-1(d) for Partnership for the partnership taxable year. After signing the consent, PR resigns as partnership representative in accordance with Section 301.6223-1(d). The consent to extend the period of limitations on making adjustments under Section 6235(b) remains valid even after PR resigns.

EXAMPLE 5

Reg. 301.6223-2(e)

Partnership designates a partnership representative who does not make himself available to meet with the IRS in person in the United States as required by Section 301.6223-1(b). Although the partnership representative does not have substantial presence in the United States within the meaning of Section 301.6223-1(b)(2), until a termination occurs under Section 301.6223-1(d) or (e) or the IRS determines the partnership representative designation is no longer in effect under Section 301.6223-1(f), the partnership representative designation remains in effect, and Partnership and all its partners are bound by the actions of the partnership representative.

Partnership designates PR1 as the partnership representative on its timely filed partnership return for 2020. On September 1, 2022, the IRS sends a NAP for the 2020 taxable year to Partnership and PR, and Partnership revokes PR1's designation and designates PR2 as the partnership representative in accordance with Section 301.6223-1(e). On November 1, 2023, PR2 consents to an extension of the period of limitations on making adjustments under Section 6235(b) and Section 301.6235(d) for Partnership's 2020 taxable year. On December 1, 2023, the IRS then withdraws the NAP. PR2 remains the partnership representative, and the

consent to extend the period of limitations on making adjustments under Section 6235(b) remains valid even after the NAP is withdrawn.

Remaining Final Regulations

The IRS submitted the remaining final regulations for publication in the Federal Register on December 21, 2018. These regulations are based initially upon the proposed regulations issued in mid-2017, then reissued to take into account the changes made in the 2018 Consolidated Appropriations Act in mid-2018. The final regulations largely follow the proposed regulations as revised.

Over the next few units, we'll look at various portions of these regulations.

Scope of the Regime

The IRS defends taking a broad view of the applicability of the provisions, explaining that the agency does not believe that Congress intended for the items to be covered to be less comprehensive than found under prior TEFRA audits, but rather to be broader in scope. This adherence to the prior TEFRA principles continued after the changes made in the CAA.

Thus, all items relating to the partnership are to be determined at the partnership level. Any Chapter 1 tax (that is, income tax) arising from such adjustments are to be collected at the partnership level (Reg. Section 301.6221(a)-1(a)).

Taxes outside of Chapter 1 are not covered by this regulation; rather, the IRS can institute other proceedings against the partners for such taxes. As the preamble to the proposed regulations notes:

> [i]n some circumstances, adjustments made under the centralized partnership audit regime may have an effect on the determination of taxes imposed by provisions of the Code outside of chapter 1. For example, if it is determined in a proceeding under the centralized partnership audit regime that a partnership has additional unreported ordinary income, that determination could form the basis for a separate determination that one or more of the partners in that partnership owe additional self-employment tax under chapter 2 of the Code.

> Additionally, as clarified in proposed Section 301.6221(a)-1(d), determinations regarding items covered by the centralized partnership audit regime may be relied upon by the IRS when making determinations of taxes not covered by chapter 1 to the extent they are relevant in making such determinations. For instance, if the IRS determines as part of the centralized partnership audit regime that an individual who is treated as a partner in the partnership has received additional unreported ordinary income from the partnership, the IRS is not precluded from separately examining the partnership or that individual for purposes of determining whether that individual is an employee and not a partner of the partnership for purposes of imposing subtitle C employment taxes with regard to that income or examining the individual for purposes of determining whether the individual owes additional self-employment tax on the income. Any such determinations made in a separate examination outside the centralized partnership audit regime will be solely for purposes of the taxes not covered by chapter 1, will not constitute determinations for purposes of chapter 1, and will not constitute an administrative proceeding with respect to the partnership for purposes of subchapter C of chapter 63. The IRS may use all procedures available, such as obtaining the books and records of the partnership, to make determinations of items covered by the centralized partnership audit regime solely for purposes of taxes not covered by chapter 1. Any determinations for taxes other than chapter 1 taxes are not covered by the centralized partnership audit regime under subchapter C of chapter 63.

Reg. Section 301.6241-1(a)(6)(ii) provides that the phrase "partnership-related item" means:

> *The term partnership-related item means—*
>
> *(A) Any item or amount with respect to the partnership (as defined in paragraph (a)(6)(iii) of this section) which is relevant in determining the tax liability of any person under chapter 1 of the Code (chapter 1) (as defined in paragraph (a)(6)(iv) of this section);*
>
> *(B) Any partner's distributive share of any such item or amount; and*
>
> *(C) Any imputed underpayment determined under subchapter C of chapter 63 of the Code (subchapter C of chapter 63).*

The item or amount with respect to the partnership is defined as:

> *. . . [A]n item or amount is with respect to the partnership if the item or amount is shown or reflected, or required to be shown or reflected, on a return of the partnership under Section 6031, the regulations thereunder, or the forms and instructions prescribed by the Internal Revenue Service (IRS) for the partnership's taxable year or is required to be maintained in the partnership's books or records. Items or amounts relating to any transaction with, liability of, or basis in the partnership are with respect to the partnership only if those items or amounts are described in the preceding sentence. An item or amount shown or required to be shown on a return of a person other than the partnership (or in that person's books and records) that results after application of the Code to a partnership-related item based upon the person's specific facts and circumstances, including an incorrect application of the Code or taking into account erroneous facts and circumstances of the partner, is not an item or amount with respect to the partnership. For instance, a deduction shown on the return of a partner that results after applying a limitation under the Code (such as Section 170(b)) at the partner level to a partnership-related item based on the partner's facts and circumstances is not an item or amount with respect to the partnership, even though the corresponding expense on the return of the partnership is an item or amount with respect to the*

partnership. Likewise, an amount on the return of a partner that is after either an incorrect application of a limitation under the Code or based on facts and circumstances of the partner that are erroneous, or both (such as an incorrect application of Section 170(b)) at the partner level to a partnership-related item is not an item or amount with respect to the partnership. Similarly, a partner's adjusted basis is not with respect to the partnership because it is an item or amount shown in the partner's books or records that results after application of the Code to partnership-related items taking into account the facts and circumstances specific to that partner.[157]

An item is relevant in determining the tax liability of any person under chapter 1 of the IRC in the following cases:

For purposes of this section, an item or amount with respect to the partnership is relevant in determining the tax liability of any person under chapter 1 without regard to the application of subchapter C of chapter 63 and without regard to whether such item or amount, or an adjustment to such item or amount, has an effect on the tax liability of any particular person under chapter 1.[158]

Examples of partnership-related items per the regulations are:

(A) The character, timing, source, and amount of the partnership's income, gain, loss, deductions, and credits;

(B) The character, timing, and source of the partnership's activities;

(C) The character, timing, source, value, and amount of any contributions to, and distributions from, the partnership;

(D) The partnership's basis in its assets, the character and type of the assets, and the value (or revaluation such as under Section 1.704-1(b)(2)(iv)(f) or (s) of this chapter) of the assets;

(E) The amount and character of partnership liabilities and any changes to those liabilities from the preceding tax year;

(F) The category, timing, and amount of the partnership's creditable expenditures;

(G) Any item or amount resulting from a partnership termination;

(H) Any item or amount of the partnership resulting from an election under Section 754;

(I) Partnership allocations and any special allocations; and

(J) The identity of a person as a partner in the partnership.[159]

The regulations provide six examples of the application of partnership-related items:[160]

(A) Example 1. Partnership enters into a transaction with A to purchase widgets for $100 in taxable year 2020. Partnership pays A $100 for the widgets. Any deduction or expense of the

[157] Reg. Section 301.6241-1(a)(6)(iii)
[158] Reg. Section 301.6241-1(a)(6)(iv)
[159] Reg. Section 301.6241-1(a)(6)(v)
[160] Reg. Section 301.6241-1(a)(6)(vi)

Partnership for the purchase of the widgets is an item or amount with respect to Partnership because it is shown on Partnership's return and is relevant to determining the liability of any person under chapter 1 pursuant to paragraph (a)(6)(iii) and (iv) of this section. Therefore, the deduction or expense is a partnership-related item. However, the income to A resulting from the transaction with Partnership is not an item or amount with respect to Partnership under paragraph (a)(6)(iii) of this section because although the amount of income relates to a transaction with Partnership and Partnership is required to show a deduction or expense related to the payment to A, the amount of income to A is not shown or required to be shown on Partnership's return. It is only required to be shown of the return of A, a person other than Partnership and requires determinations about A's reporting of the item. Accordingly, the amount of income shown, or required to be shown, by A on his return is not a partnership-related item.

(B) Example 2. B loans Partnership $100 in Partnership's 2020 taxable year. Partnership makes an interest payment to B in 2020 of $5. Partnership's liability relating to the loan by B to Partnership and the $5 of interest expense paid by the Partnership are items or amounts that are with respect to Partnership because they were shown on Partnership's return and are relevant in determining the liability of any person under chapter 1 pursuant to paragraphs (a)(6)(iii) and (iv) of this section. However, the treatment of the loan by B and the amount of interest income received by B are not items or amounts with respect to Partnership under paragraph (a)(6)(iii) of this section because although they relate to a transaction with or liability of Partnership and Partnership's treatment of the loan is shown on Partnership's return, B's treatment of the loan and the amount of interest income to B are shown, or required to be shown, on the return of B, a person other than Partnership and require determinations about B's reporting of the items. Accordingly, the loan as treated by B and the amount of interest income to B is not a partnership-related item.

(C) Example 3. On its partnership return for the 2020 tax year, Partnership reported $200 of non-cash charitable contributions related to its contribution of merchandise. Partnership has two equal partners for the 2020 tax year: C and D, both individuals. Partnership correctly reports $100 in non-cash charitable contributions to both C and D for the 2020 taxable year. On her return for the 2020 taxable year, C erroneously deducts the entire $100 of non-cash charitable contributions, even though C's deduction for charitable contributions would be limited by Section 170(b)(1)(A) to $50 because of C's income. The $100 of non-cash charitable contribution reported by Partnership to C is a partnership-related item. However, the amount of the deduction taken by C on her return for 2020 and the amount of that deduction allowed after application of the limitation contained in Section 170(b)(1)(A) to the $100 in non-cash charitable contributions reported by Partnership to C is not a partnership-related item under paragraph (a)(6)(ii) of this section because it is not with respect to the partnership.

(D) Example 4. The facts are the same as in Example 3 in paragraph (a)(6)(vi)(C) of this section. On his return for the 2020 taxable year, D also deducts the entire $100 in charitable contributions but treats the charitable contributions as if they were cash contributions, instead of non-cash contributions. D does not file a notice of inconsistent treatment under Section 6222. If D had treated the $100 in charitable contributions as non-cash contributions, D's deduction for the charitable contributions from Partnership would have be limited by Section 170(b)(1)(A) due to D's income. D's deduction of the $100 in charitable contributions is an item or amount shown on D's return, derives from the charitable contributions reported by the partnership, and is subject to the application of the limitation under Section 170(b)(1)(A). Therefore, D's deduction is not an item or amount with respect to the partnership. The charitable contribution reported by the partnership and its character are items or amounts with respect to the partnership pursuant to paragraph (a)(6)(iii) of this section. An adjustment to the character of the contributions is a partnership adjustment. Because D's treatment of the charitable contributions is inconsistent with the treatment of that item by Partnership on its partnership return, the IRS may make that

partnership adjustment in a proceeding with respect to D and determine and assess any underpayment that results from conforming D's treatment to the treatment of the contributions by Partnership and applying the limit in Section 170(b)(1)(A). See Section 301.6222-1(b).

Consistent Treatment of Items by Partners

Like the provisions under the TEFRA partnership audit regime that will be replaced by the BBA regime, a partner generally is bound to report an item on his return consistent with the partnership's treatment (IRC Section 6222). Reg. Section 301.6222-1(a)(1) provides that to meet this requirement, the "treatment of partnership-related items (as defined in Section 301.6241-1(a)(6)(ii) on a partner's return must be consistent with the treatment of those items on the partnership return in all respects, including the amount, timing, and characterization of those items."

The IRS emphasizes that the reporting must be consistent with the return filed, even if the partnership provided other information. As Reg. Section 301.6222-1(a)(1) continues:

> (a) partner has not satisfied the requirement of this paragraph (a) if the treatment of the partnership-related item on the partner's return is consistent with how such item was treated on a schedule or other information furnished to the partner by the partnership but inconsistent with the treatment of the item on the partnership return actually filed. For rules relating to the election to be treated as having reported the inconsistency where the partner treats the partnership-related item consistently with an incorrect schedule or other information furnished by the partnership, see paragraph (d) of this section.

The rules apply to all partners, including partners that are themselves partnerships and have filed a valid election out of the BBA partnership audit regime (Reg. Section 301.6222-1(a) (2)).

If a partnership does not file a tax return, then the partner's treatment of the item is automatically inconsistent with that of the partnership.[161]

The proposed regulations define the treatment of an item by the partnership in the following manner:

- The treatment of an item on the partnership's return of partnership income filed with the IRS under Section 6031, and any amendment or supplement thereto, including an administrative adjustment request (AAR) filed pursuant to Section 6227 and the regulations thereunder.

- The treatment of such item on any statement, schedule, or list, and any amendment or supplement thereto, filed by the partnership with the IRS, including any statements filed pursuant to Section 6226 and the regulations thereunder (Reg. Section 301.6222-1(a) (4)).

The IRS provides the following examples at Reg. Section 301.6222-1(a)(5):

EXAMPLE 1

A is a partner in Partnership during 2018 and 2019. In December 2018, Partnership receives an advance payment for services to be performed in 2019 and reports this amount as income on its partnership return for 2018. A includes its distributive share of income from the advance payment on A's income tax return for

[161] Reg. Section 301.6221-(a)(3)

2019 and not on A's income tax return for 2018. A has not satisfied the requirements of paragraph (a) of this section because A's treatment of the income attributable to Partnership is inconsistent with the treatment of that item by Partnership on its partnership return.

EXAMPLE 2

B is a partner in Partnership during 2018. Partnership incurred start-up costs before it was actively engaged in its business. Partnership capitalized these costs on its 2018 partnership return. B deducted his distributive share of the start-up costs on B's 2018 income tax return. B has not satisfied the requirements of paragraph (a) of this section because B's treatment of the start-up costs is inconsistent with the treatment of that item by Partnership on its partnership return.

EXAMPLE 3

C is a partner in Partnership during 2018. Partnership reports a loss of $100,000 on its partnership return for 2018. On the 2018 Schedule K-1 attached to the partnership return, Partnership reports $5,000 as C's distributive share of that loss. On the 2018 Schedule K-1 furnished to C, however, Partnership reports $15,000 as C's distributive share of the loss. C reports the $15,000 loss on C's 2018 income tax return. C has not satisfied the requirements of paragraph (a) of this section because C reported C's distributive share of the loss in a manner that is inconsistent with how C's distributive share of the loss was reported on the 2018 partnership return actually filed. See, however, paragraph (d) of this section for the election to be treated as having reported the inconsistency where the partner treats an item consistently with an incorrect schedule.

EXAMPLE 4

D was a partner in Partnership during 2018. Partnership reports a loss of $100,000 on its partnership return for 2018. In 2020, Partnership files an AAR under Section 6227 reporting that the amount of the loss on its 2018 partnership return is $90,000, rather than $100,000 as originally reported. Pursuant to Section 6227, Partnership elects to have its partners take the adjustment into account, and furnishes D a statement showing D's share of the reduced loss for 2018. D fails to take his share of the reduced loss for 2018 into account in accordance with Section 6227. D has not satisfied the requirements of paragraph (a) of this section because D has not taken into account his share of the loss in a manner consistent with how Partnership treated such items on the partnership return actually filed.

EXAMPLE 5

E was a partner in Partnership during 2018. In 2021, Partnership receives a notice of final partnership adjustment (FPA) in an administrative proceeding under subchapter C of chapter 63 with respect to Partnership's 2018 taxable year. The FPA reflects an imputed underpayment. Partnership properly elects the application of Section 6226 with respect to the imputed underpayment and files with the IRS and furnishes to E a statement of E's share of adjustments with respect to Partnership's 2018 taxable year. E fails to take his share of the adjustments into account in accordance with Section 6226. E has not satisfied the requirements of paragraph (a) of this section because E has not taken into account his share of adjustments with respect to Partnership's 2018 taxable year in a manner consistent with how Partnership treated such items on the Section 6226 statement filed with the IRS.

EXAMPLE 6

F was a partner in Partnership during 2018. F has a valid election under Section 6221(b) in effect with respect to F's 2018 partnership taxable year. Notwithstanding F's election under Section 6221(b) for its 2018 taxable year, F is subject to Section 6222 for taxable year 2018. F must treat, on its 2018 partnership return, any items attributable to F's interest in Partnership in a manner that is consistent with the treatment of those items on the 2018 partnership return actually filed by Partnership.

EXAMPLE 7

G was a partner in Partnership during 2018. G's taxable year ends on the same day as Partnership's 2018 taxable year. Partnership did not file a partnership return for its 2018 taxable year. G files an income tax return for its 2018 taxable year and reports G's share of a loss attributable to G's interest in Partnership. Because Partnership failed to file a partnership return, G's treatment of such loss is per se inconsistent pursuant to paragraph (a)(3) of this section.

Underpayment Resulting from Inconsistent Treatment

Reg. Section 301.6222-1(b)(1) provides the following for determination of the underpayment of tax resulting from an inconsistent treatment:

> If a partner fails to satisfy the requirements of paragraph (a) of this section, unless the partner provides notice in accordance with paragraph (c) of this section, the IRS may adjust the inconsistently reported partnership-related item on the partner's return to make it consistent with the treatment of such item on the partnership return (or where no partnership return was filed, remove any treatment of such item from the partner's return) and determine any underpayment of tax that results from that adjustment. For purposes of this section, except as provided in (b)(3) of this section, the underpayment of tax is the amount by which the correct tax, as determined by making the partner's return consistent with the partnership return, exceeds the tax shown on the partner's return.
>
> The reference to (b)(3) in the above relates to when the partner is a partnership.

Collection of Tax from Inconsistent Treatment

As Reg. Section 301.6222-1(b)(2) notes, the law allows for the IRS to collect that tax under a math error treatment that provides fewer options than a normal math error collection.

> The IRS may assess and collect any underpayment of tax resulting from an adjustment described in paragraph (b)(1) of this section in the same manner as if the underpayment of tax were on account of a mathematical or clerical error appearing on the partner's return, except that the procedures under Section 6213(b)(2) for requesting abatement of an assessment do not apply.
>
> The regulations as re-proposed on August 17, 2018, have the same language in this regard. Federal Register, August 17, 2018, p. 41,972.

The IRS provides the following examples of dealing with the underpayment of tax resulting from an inconsistent treatment:

EXAMPLE 1

H, an individual, is a partner in Partnership. On its partnership return for taxable year 2018, Partnership reports $100,000 in ordinary income. On the Schedule K-1 attached to the partnership return, as well as on the Schedule K-1 furnished to H, Partnership reports $15,000 as H's distributive share of the $100,000 in ordinary income. H reports only $5,000 of the $15,000 of ordinary income on his 2018 income tax return. The IRS may determine the amount of tax that results from adjusting the ordinary income attributable to H's interest in Partnership reported on H's 2018 income tax return from $5,000 to $15,000 and assess that resulting underpayment in tax as if it were on account of a mathematical or clerical error appearing on H's return. H may not request an abatement of that assessment under Section 6213(b).

EXAMPLE 2

J was a partner in Partnership during 2018. In 2021, Partnership receives an FPA in an administrative proceeding under subchapter C of chapter 63 with respect to Partnership's 2018 taxable year. The FPA reflects an imputed underpayment. Partnership properly elects the application of Section 6226 with respect to the imputed underpayment and files with the IRS and furnishes to J a statement of J's share of adjustments with respect to Partnership's 2018 taxable year. J fails to report one adjustment reflected on the statement, J's share of a decrease in the amount of losses for 2018, on J's return as required by Section 6226. The IRS may determine the amount of tax that results from adjusting the decrease in the amount of losses on J's return to be consistent with the amount included on the Section 6226 statement filed with the IRS and may assess the resulting underpayment in tax as if it were on account of a mathematical or clerical error appearing on J's return. J may not request an abatement of that assessment under Section 6213(b).

Partner's Notice of Inconsistent Treatment

The law does provide a partner an option to report inconsistently—but the partner has to report that inconsistent treatment to the IRS (Reg. Section 301.6222-1(c)(1)). The protection provided is described by Reg. Section 301.6222-1(c)(3).

> *Paragraphs (a) and (b) of this section (regarding the consistent treatment of partnership-related items and the effect of inconsistent treatment) do not apply to partnership-related items identified as inconsistent (or that may be inconsistent) in a statement that the partner provides to the IRS according to the forms, instructions, and other guidance prescribed by the IRS. Instead, the procedures in paragraph (c)(3) of this section apply. A statement does not identify an inconsistency for purposes of this paragraph (c) unless it is attached to the partner's return on which the partnership-related item is treated inconsistently.*

If such a notice is provided, the IRS can make adjustments via a partner-level proceeding. As Reg. Section 301.6222-1(c)(4)(i) notes:

> In general, if a partner notifies the IRS of the inconsistent treatment of a partnership-related item in accordance with paragraph (c)(1) of this section, and the IRS disagrees with the inconsistent treatment, the IRS may adjust the identified, inconsistently reported item in a proceeding with respect to the partner. Nothing in this paragraph (c)(4)(i) precludes the IRS from also conducting a proceeding with

> respect to the partnership. If the IRS conducts a proceeding with respect to the partnership regarding the identified, inconsistently reported item, each partner of the partnership, including any partner that notified the IRS of inconsistent treatment in accordance with paragraph (c)(1) of this section, is bound by actions taken by the partnership and by any final decision in the proceeding with respect to the partnership. See paragraph (c)(2) of this section.

The nature of that partner-level proceeding is described in Reg. Section 301.6222-1(c)(4)(ii).

> In a proceeding with respect to a partner described in paragraph (c)(4)(i) of this section, the IRS may adjust any identified, inconsistently reported partnership-related item to make the item consistent with the treatment of that item on the partnership return or determine that the correct treatment of such item differs from the treatment on the partnership return and instead adjust the item to reflect the correct treatment, notwithstanding the treatment of that item on the partnership return. The IRS may also adjust any item on the partner's return, including items that are not partnership-related items. Any final decision with respect to an inconsistent position in a proceeding to which the partnership is not a party is not binding on the partnership.

Reg. Section 301.6221-1(c)(5) provides that once a notice of administrative proceeding with respect to a partnership taxable tax year has been mailed by the IRS, a partner may no longer file a notice of inconsistent treatment with the IRS with regard to any partnership-related item differently than the partnership return, except as provided in Section 301 for cases allowed under Reg. Section 301.6225-1 (Regs. Section 301.6222-1(c)(5)) (generally for amended returns filed by partners for a modification of the imputed underpayment). The IRS gives the following two examples of applying the notification of inconsistent treatment provisions at Reg. Section 301.6222-1(c)(6):

EXAMPLE 1

K is a partner in Partnership during 2018. K treats a deduction and a capital gain attributable to Partnership on K's 2018 income tax return in a manner that is inconsistent with the treatment of those items by Partnership on its 2018 partnership return. K reports the inconsistent treatment of the deduction in accordance with paragraph (c)(1) of this section, but not the inconsistent treatment of the gain. Because K did not notify the IRS of the inconsistent treatment of the gain in accordance with paragraph (c)(1) of this section, the IRS may determine the amount of tax that results from adjusting the gain reported on K's 2018 income tax return in order to make the treatment of that gain consistent with how the gain was treated on Partnership's partnership return. Pursuant to paragraph (c)(3) of this section, the IRS may assess and collect the underpayment of tax resulting from the adjustment to the gain as if it were on account of a mathematical or clerical error appearing on K's return.

EXAMPLE 2

L is a partner in Partnership during 2018. On its 2018 partnership return, Partnership treats partner L's distributive share of ordinary loss attributable to Partnership as $8,000. L, however, claims an ordinary loss of $9,000 as attributable to Partnership on its 2018 income tax return and notifies the IRS of the inconsistent treatment in accordance with paragraph (c)(1) of this section. As a result of the notice of inconsistent treatment, the IRS conducts a separate proceeding under subchapter B of chapter 63 of the Internal Revenue Code with respect to L's 2018 income tax return, a proceeding to which Partnership is not a party. During the proceeding, the IRS determines that the proper amount of L's distributive share of the ordinary loss from Partnership is $3,000. During the same proceeding, the IRS also determines that L overstated a

charitable contribution deduction in the amount of $2,500 on its 2018 income tax return. The determination of the adjustment of L's share of ordinary loss is not binding on Partnership. The charitable contribution deduction is not attributable to Partnership or to another partnership subject to the provisions of subchapter C of chapter 63. The IRS may determine the amount of tax that results from adjusting the $9,000 ordinary loss deduction to $3,000 and from adjusting the charitable contribution deduction. Pursuant to paragraph (c)(4)(ii) of this section, the IRS is not limited to only adjusting the ordinary loss of $9,000, as originally reported on L's partner return, to $8,000, as originally reported by Partnership on its partnership return, nor is the IRS prohibited from adjusting the charitable contribution deduction in the proceeding with respect to L.

Partner's Receipt of Incorrect Information

The law provides an option for a partner to make a late election of inconsistent treatment if the partnership provides the partner a K-1 that is not consistent with what the partnership files with its tax return. Per Reg. Section 301.6222-1(d)(1), the partner can take advantage of this rule if the partner:

- demonstrates that the treatment of the item on the partner's return is consistent with the treatment of that item on the statement, schedule, or other form prescribed by the IRS and furnished to the partner by the partnership, and
- makes an election in accordance with paragraph (d)(2) of this section.

The taxpayer must file the election within 60 days of being notified by the IRS of inconsistent treatment (Reg. Section 301.6222-1(d)(2)(i)). The election must:

- be clearly identified as an election under Section 6222(c)(2)(B);
- be signed by the partner making the election;
- be accompanied by a copy of the statement, schedule, or other form furnished to the partner by the partnership and a copy of the IRS notice that notified the partner of the inconsistency; and
- include any other information required in forms, instructions, or other guidance prescribed by the IRS (Reg. Section 301.6222-1(d)(2)(ii)).

If it is not clear exactly how the taxpayer's reporting on his return is consistent with the K-1 received, additional information is required. Reg. Section 301.6222-1(d)(2)(iii) provides:

> if it is not clear from the statement, schedule, or other form furnished by the partnership that the partner's treatment of such item on the partner's return is consistent, the election must also include an explanation of how the treatment of such item on the statement, schedule, or other form furnished by the partnership is consistent with the treatment of the item on the partner's return, including with respect to the characterization, timing, and amount of such item.

The IRS provides the following example related to the election after receipt of inconsistent information (Reg. Section 301.6222-1(d)(3)):

EXAMPLE

M is a partner in Partnership for 2018. Partnership is subject to subchapter C of chapter 63, and both Partnership and M are calendar year taxpayers. On its 2018 partnership return, Partnership reports that M's distributive share of ordinary income attributable to Partnership is $1,000. Partnership furnishes to M a Schedule K-1 for 2018 showing $500 as M's distributive share of ordinary income. M reports $500 of ordinary income attributable to Partnership on its 2018 income tax return consistent with the Schedule K-1 furnished to M. The IRS notifies M that M's treatment of the ordinary income attributable to Partnership on its 2018 income tax return is inconsistent with how Partnership treated the ordinary income allocated to M on its 2018 partnership return. Within 60 days of receiving the notice from the IRS of the inconsistency, M files an election with the IRS in accordance with paragraph (d)(2) of this section. Because M made a valid election under Section 6222(c)(2)(B) and paragraph (d)(1) of this section, M is treated as having notified the IRS of the inconsistency with respect to the ordinary income attributable to Partnership under paragraph (c)(1) of this section.

Application of Provisions in the Case of Early Election of BBA Provisions

If a partnership elects early application of the BBA audit regime for a tax year beginning after November 2, 2015, and before January 1, 2018, the rules of this provision would apply to that examination. The introduction to the final regulations issued in 2019 is summarized as follows:

> "This document contains final regulations implementing the centralized partnership audit regime. These final regulations affect partnerships for taxable years beginning after December 31, 2017 and ending after August 12, 2018, as well as partnerships that make the election to apply the centralized partnership audit regime to partnership taxable years beginning on or after November 2, 2015, and before January 1, 2018." (TD 9844)

Partnership Adjustment by the IRS

The IRS's computation of the imputed adjustment is the fundamental change from the TEFRA examination regime in place prior to the new BBA regime. Reg. Section 301.6225-1 outlines how the process of the IRS coming to the imputed underpayment will work.

The imputed adjustment is treated as a tax imposed in the adjustment year (Reg. Section 301.6225-1(a)(1) refers to the definition in Regs. 301.6241-1(a)(1) in accordance with Regs. Section 301.6225-3). The adjustment year is:

- [i]n the case of an adjustment pursuant to the decision of a court in a proceeding brought under Section 6234, whensuch decision becomes final;
- [i]n the case of an administrative adjustment request (AAR) under Section 6227, when such AAR is filed; or

- [i]n any other case, when a notice of final partnership adjustment is mailed under Section 6231 or, if the partnership waives the restrictions under Section 6232(b) (regarding limitations on assessment), the date the waiver is executed by the IRS (Reg. Section 301.6241-1(a)(1)).

The notice of final partnership adjustment will contain the amount of the imputed underpayment unless the partnership waives its right to such notice (Reg. Section 301.6225-1(a)).

If the partnership pays an imputed underpayment, the amount is treated as a nondeductible expenditure. That includes not only the tax and penalties, but also any interest paid by the partnership (Reg. Section 301.6225-1(a) and 301.6241-4(a)).

The imputed adjustment contained in the notice of partnership adjustment is the adjustment prior to any modifications requested by the partnership (Reg. Section 301.6225-1(a)(3), Reg. Section 301.6225-2). This amount may be reduced if the partnership determines it wishes to follow the procedures for reducing the imputed underpayment as provided for in the proposed regulations.

Adjustments That Do Not Result in an Imputed Underpayment

If an adjustment does not result in an imputed underpayment (for instance, the exam determines the partnership reported income in excess of what should have been reported or a specific subgrouping does not result in an underpayment), the adjustment is taken into account by the partnership in the adjustment year (Reg. Section 301.6225-3(a)) as follows:

- To the extent the adjustment involves separately stated items under IRC Section 702, the adjustment is taken into account to increase or decrease the related separately stated item in the adjustment year.

- Other adjustments of income and deductions are taken into account by increasing or decreasing non-separately income and loss for the adjustment year.

- Adjustments to credits are separately stated items in the adjustment year (Reg. Section 301.6225-3(b)(1)-(3)).

The allocation of the adjustments in this case is complicated by the fact that individuals and entities that were partners in the year under exam (the reviewed year) quite often will not be the same as those that are partners in the adjustment year (roughly the year the exam becomes final). Reg. Section 301.6225-3(b)(4) provides the following regarding the allocation process.

> A partnership adjustment that reallocates a partnership-related item to or from a particular partner or partners that also does not result in an imputed underpayment pursuant to Section 301.6225–1(f) is taken into account by the partnership in the adjustment year as a separately stated item or a non-separately stated item, as required by Section 702. Except as provided in forms, instructions, and other guidance prescribed by the Internal Revenue Service (IRS), the portion of an adjustment allocated under this paragraph (b)(4) is allocated to adjustment year partners (as defined in Section 301.6241–1(a)(2)) who are also reviewed year partners (as defined in Section 301.6241–1(a)(9)) with respect to whom the amount was reallocated.

Calculation of the Imputed Underpayment

The calculation of the imputed underpayment that will be part of the notice of partnership adjustment is calculated by:

- multiplying the total netted partnership adjustment by the highest rate of federal income tax in effect for the reviewed year, and

- increasing or decreasing the product by the net increase or net decrease in credits resulting from partnership adjustments (Reg. Section 301.6225-1(c)(1)).

The "netted partnership adjustment" is defined as:

- the sum of all net positive adjustments in the residual grouping plus

- the sum of all net positive adjustments in the reallocation grouping (Reg. Section 301.6225-1(c)(3)).

There is no netting between years in computing an imputed adjustment—each year stands on its own (Reg. Section 301.6225-1(c)(4)).

A partnership adjustment does not result in an imputed underpayment under any of the following three conditions:

- After grouping and netting the adjustments as described in paragraph (d) of this section, the result of netting any grouping or subgrouping is a net non-positive adjustment.

- The calculation of the imputed underpayment results in an amount that is zero or less than zero (Reg. Section 301.6225-1(f)).

Groupings of Adjustments

Reg. Section 301.6225-1(c)(1) outlines the groupings used in computing the imputed underpayment. The general rule is outlined as follows:

> "To determine an imputed underpayment under paragraph (b) of this section, partnership adjustments are placed into one of four groupings. These groupings are the reallocation grouping described in paragraph (c)(2) of this section, the credit grouping described in paragraph (c)(3) of this section, the creditable expenditure grouping described in paragraph (c)(4) of this section, and the residual grouping described in paragraph (c)(5) of this section. Adjustments in groupings may be placed in subgroupings, as appropriate, in accordance with paragraph (d) of this section. The IRS may, in its discretion, group adjustments in a manner other than the manner described in this paragraph (c) when such grouping would appropriately reflect the facts and circumstances. For requests to modify the groupings, see Section 301.6225–2(d)(6)."

The general definition of a reallocation adjustment is as follows: "Any adjustment that allocates or reallocates a partnership-related item to and from a particular partner or partners is a reallocation adjustment."

The regulation goes on to state: "Each reallocation adjustment generally results in at least two separate adjustments. One adjustment reverses the effect of the improper allocation of a partnership-related item, and the other adjustment effectuates the proper allocation of the partnership-related item. Generally, a reallocation adjustment results in one positive adjustment (as defined in paragraph (d)(2)(iii) of this section) and one negative adjustment (as defined in paragraph (d)(2)(ii) of this section)."

Subgroups

The regulation goes to discuss the credit grouping as follows: "Each adjustment to a partnership-related item that is reported or could be reported by a partnership as a credit on the partnership's return, including a reallocation adjustment, is placed in the credit grouping." (Regs. Section 301.6225-1(c')(3))

While the regulation provides a method to subgroup adjustments in the regulation, those will not necessarily be the ones used. As the regulation notes:

The IRS may, in its discretion, subgroup adjustments in a manner other than the manner described in this paragraph (d) when such subgrouping would be appropriate." For requests to modify the subgroupings, see Section 301.6225-2(d)(6).

Partnership adjustments within each grouping or subgrouping are netted together to determine if there is a net positive or non-positive adjustment within each category. However, the various categories or subcategories are not to be netted against each other (Reg. Section 301.6225-1(e)'). The regulation explains:

The following is a basic definition for classifying each adjustment:

(A) An increase in an item of gain is treated as an increase in an item of income;

(B) A decrease in an item of gain is treated as a decrease in an item of income;

(C) An increase in an item of loss or deduction is treated as a decrease in an item of income; and

(D) A decrease in an item of loss or deduction is treated as an increase in an item of income.

A negative adjustment is defined as any adjustment that is a decrease in an item of income, a partnership adjustment of those listed as a decrease in an item of income, or an increase in an item of credit. A positive adjustment is any adjustment that does not meet the definition of a negative adjustment.

The regulation provides a special rule to deal with adjustments that cannot be allocated under IRC Section 704(b):

> For purposes of determining an imputed underpayment under this section, an adjustment described in paragraph (c)(5)(ii) of this section that could result in an increase in income or decrease in a loss, deduction, or credit for any person without regard to any particular person's specific circumstances is treated, to the extent appropriate, either as a positive adjustment to income or to a credit.

The general rules for subgrouping are outlined as follows:

> . . . [A]n adjustment is subgrouped according to how the adjustment would be required to be taken into account separately under Section 702(a) or any other provision of the Code, regulations, forms, instructions, or other guidance prescribed by the IRS applicable to the adjusted partnership-related item. A negative adjustment must be placed in the same subgrouping as another adjustment if the negative adjustment and the other adjustment would have been properly netted at the partnership level and such netted amount would have been required to be allocated to the partners of the partnership as a single partnership-related item for purposes of Section 702(a), other provision of the Code, regulations, forms, instructions, or other guidance prescribed by the IRS. For purposes of creating subgroupings under this section, if any adjustment could be subject to any preference, limitation, or restriction under the Code (or not allowed, in whole or in part, against ordinary income) if taken into account by any person, the adjustment is placed in a separate subgrouping from all other adjustments within the grouping.

The regulations go on to provide specific rules for subgrouping the various sets of groupings.

Subgrouping Reallocation Adjustments

Each positive and each negative adjustment that results from a reallocation adjustment is placed in a separate subgrouping within the reallocation group.

For instance, if the reallocation adjustment reallocates a deduction from one partner to another partner, the decrease in the deduction (positive adjustment) allocated to the first partner is placed in a subgrouping within the reallocation grouping separate from the increase in the deduction (negative adjustment) allocated to the second partner.

However, if one partner or a group of partners have two or more reallocation adjustments allocable to the partner or group, these reallocation adjustments may be netted under the standard rules for adjustments.

Subgrouping Reallocation Adjustments in the Credit Grouping

If there is a reallocation of credits, the regulation provides the following rules for subgrouping:

> . . . [T]he decrease in credits allocable to one partner or group of partners is treated as a positive adjustment, and the increase in credits allocable to another partner or group of partners is treated as a negative adjustment. Each positive adjustment and each negative adjustment resulting from a reallocation adjustment to credits is placed in its own separate subgrouping within the credit grouping.

Subgroupings in the Creditable Expenditure Group

The regulations eventually will provide a general rule for subgroupings in the creditable expenditure group, and a special rule for dealing with CFTEs. For creditable expenditure adjustments other than CFTEs, the regulations provide that the general subgrouping rules will apply but also reference the reader to special rules to be found at Reg. Section 301.6225-1(d)(3)(iii)(C). However, there are no regulations to be found there, just a "[Reserved]" line.

The preamble to the final regulations explains the status of these adjustments as follows:

> The Treasury Department and the IRS requested comments on the appropriate treatment of creditable expenditures. One comment suggested any items that may be treated as a credit when taken into account by a partner and not otherwise limited (for instance, by their non-creditable status against the alternative minimum tax) be credited against the imputed underpayment amount. For other items which may be subject to limitations at the individual level, the comment suggested that the regulations provide rules similar to those rules proposed under proposed Section 301.6225-3, regarding adjustments that do not result in an imputed underpayment, because any adjustment to a credit would not result in an imputed underpayment.

With the exception of the rules under Section 301.6225-1 regarding foreign tax creditable expenditures, the Treasury Department and the IRS have determined not to issue regulations regarding the treatment of creditable expenditures at this time. However, the final regulations do clarify that the general subgrouping principles under Section 301.6225-1(d)(3)(i) apply when subgrouping adjustments to creditable expenditures. The comments received with respect to creditable expenditures remain under consideration, and future guidance will be issued when appropriate.

There are specific rules provided for dealing with CFTE adjustments in this category. The regulations provide:

> Each adjustment to a CFTE is subgrouped based on the separate category of income to which the CFTE relates in accordance with paragraph (d) of this section are Section 904(d) and the regulations thereunder, and to account for any different allocation of the CFTE between partners. Two or more adjustments to CFTEs are included within the same subgrouping only if each adjustment relates to CFTEs in the same separate category, and each adjusted partnership-related item would be allocated to the partners in the same ratio had those items been properly reflected on the partnership return for the reviewed year.

Subgrouping Recharacterization Adjustments

The regulations provide that, generally, each positive and negative adjustment resulting from a recharacterization adjustment is placed in its own separate subgroup in the residual grouping. However, if a single partner or group of partners has two or more recharacterization adjustments allocable to that group, the adjustments may be grouped and netted in accordance with this paragraph (e) to determine whether there is a net positive adjustment (as defined in paragraph (e)(4)(i) of this section) or net negative adjustment (as defined in paragraph (e)(4)(ii) of this section) for that subgrouping. If paragraph (d) of this section does not apply because a grouping only includes positive adjustments, all adjustments in that grouping are netted the standard rules.

Netting Adjustments Within Each Grouping or Subgrouping

Netting applies to each grouping or subgrouping and is undertaken in accordance with rules found at Reg. Section 301.6225-1(e). For purposes of this paragraph (e), netting purpose means "summing all adjustments together within each grouping or subgrouping, as appropriate."

It goes on to state: "The following limitations apply on netting adjustments:

- Positive adjustments and negative adjustments may only be netted against each other if they are in the same grouping in accordance with paragraph (c) of this section;
- If a negative adjustment is in a subgrouping in accordance with paragraph (d) of this section, the negative adjustment may only net with a positive adjustment also in that same subgrouping in accordance with paragraph (d) of this section;
- An adjustment in one grouping or subgrouping may not be netted against an adjustment in any other grouping or subgrouping. Adjustments from one taxable year may not be netted against adjustments from another taxable year." (Regs. 301.6225-1(e')(2)); and
- Adjustments from one taxable year may not be netted against adjustments from another taxable year.

Net positive adjustments are generally treated in accordance with the following provision in the regulations:

> Except as described in paragraphs (e)(3)(ii) and (iii) of this section, each net positive adjustment (as defined in paragraph (e)(4)(i) of this section) with respect to a particular grouping or subgrouping that results after netting the adjustments in accordance with this paragraph (e) is included in the calculation of the total netted partnership adjustment under paragraph (b)(2) of this section.

Net negative adjustments by default receive the following treatment:

> Each net negative adjustment (as defined in paragraph (e)(4)(ii) of this section) with respect to a grouping or subgrouping that results after netting the adjustments in accordance with this paragraph (e) is excluded from the calculation of the total netted partnership adjustment under paragraph (b)(2) of this section. Adjustments underlying a net negative adjustment described in the preceding sentence are adjustments that do not result in an imputed underpayment (as described in paragraph (f) of this section).

Credit adjustments, since they result in a direct adjustment to tax, are not generally included in the calculation of the total netted partnership adjustment. A net positive adjustment is added to the imputed underpayment. By default, a net negative adjustment is treated as an adjustment that does not result in an imputed underpayment (and thus will be treated under the procedures found at Reg. Section 301.6225-1(e)(3)(ii) unless the IRS determines the amount should be taken into account in computing the imputed underpayment.

A net decrease in any CFTE is treated as a net positive adjustment from a credit and is not included in the calculation of the netted partnership adjustment but rather a direct adjustment of tax, while an increase in any CFTE is treated as a net negative adjustment and are treated as adjustments that do not result in an imputed underpayment. Again, the IRS has reserved guidance on the treatment of other creditable expenditures.

For netting adjustments, the IRS provides a similar definition of net positive and net negative adjustments as was provided earlier.

Adjustments That Do Not Result in an Imputed Underpayment

A partnership adjustment does not result in an imputed underpayment if:

- After grouping, subgrouping, and netting, the result of netting with respect to any grouping or subgrouping that includes a particular partnership adjustment is a net negative adjustment; or
- The calculation of the imputed underpayment results in an amount that is zero or less than zero.

Adjustments that do not result in an imputed underpayment are taken into account differently depending on whether the partnership has or has not made the "push out" election under IRC Section 6226.

If no push out election is made under IRC Section 6226, the adjustment that does not result in an imputed underpayment is taken into account by the partnership in the adjustment year (year the exam concludes) as follows:

- A reduction in non-separately stated income or as an increase in non-separately stated loss for the adjustment year depending on whether the adjustment is to a partnership-related item that is an item of income or loss unless otherwise provided below;
- For separately stated items, the adjustment is taken into account by the partnership in the adjustment year as a reduction in such separately stated item or as an increase in such separately stated item depending on whether the adjustment is a reduction or an increase to the separately stated item;
- For items that are or could be reported as a credit on the reviewed year, the adjustment is taken into account by the partnership in the adjustment year as a separately stated item;
- For reallocation adjustments, the adjustment is taken into account by the partnership in the adjustment year as a separately stated item or a non-separately stated item (whichever is appropriate). The regulation provides "[e]xcept as provided in forms, instructions, and other guidance prescribed by the Internal Revenue Service (IRS), the portion of an adjustment allocated under this paragraph (b)(4) is allocated to adjustment year partners (as defined in Section 301.6241-1(a)(2)) who are also reviewed year partners (as defined in Section 301.6241-1(a)(9)) with respect to whom the amount was reallocated";
- If a partner takes the adjustment into account as part of the modification adjustment process (generally by filing an amended return) and the IRS approves the modification, the adjustment is not taken into account by the partnership in the adjustment year; and
- If, prior to the mailing of a notice of administrative proceeding by the IRS or the filing of an administrative adjustment request by the partnership, a partner has previously taken into account an adjustment that does not result in an imputed underpayment that would have been taken into account under this section, such partnership adjustment is not taken into account by such partner.

If a push out election has been made, the adjustment is taken into account by the appropriate partners in accordance with the push out rules found at Reg. Section 301.6226-3.

Multiple Imputed Underpayments in the Same Tax Year

The IRS has reserved the right to determine multiple partnership adjustments for the same partnership taxable year (Reg. Section 301.6225-1(g)).

There are two types of imputed underpayments: a general imputed underpayment and a specific imputed underpayment. Each type is separately calculated (Reg. Section 301.6225-1(g)(2)(i)).

The general imputed underpayment is defined as follows in Regs. Section 301.6225-1(g)(2)(iii)(A):

> The general imputed underpayment is calculated based on all adjustments (other than adjustments that do not result in an imputed underpayment under paragraph (f) of this section) that are not taken into account to determine a specific imputed underpayment under paragraph (g)(2)(iii) of this section. There is only one general imputed underpayment in any administrative proceeding.

The regulation provides that if there is one imputed underpayment in an administrative proceeding, it is a general imputed underpayment and may take into account specific imputed underpayments, if any, and all adjustments that do not result in that general imputed underpayment are associated with that general imputed underpayment.

The specific imputed underpayment is defined as follows in Regs. Section 301.6225-1(g)(2)(iii)(A):

> "The IRS may, in its discretion, designate a specific imputed underpayment with respect to adjustments to a partnership-related item or items that were allocated to one partner or a group of partners that had the same or similar characteristics or that participated in the same or similar transaction or on such other basis as the IRS determines properly reflects the facts and circumstances. The IRS may designate more than one specific imputed underpayment with respect to any partnership taxable year. For instance, in a single partnership taxable year, there may be a specific imputed underpayment with respect to adjustments related to a transaction affecting some, but not all, partners of the partnership (such as adjustments that are specially allocated to certain partners) and a second specific imputed underpayment with respect to adjustments resulting from a reallocation of a distributive share of income from one partner to another partner. The IRS may, in its discretion, determine that partnership adjustments that could be taken into account to calculate one or more specific imputed underpayments under this paragraph (g)(2)(iii)(A) for a partnership taxable year are more appropriately taken into account in determining the general imputed underpayment for such taxable year. For instance, the IRS may determine that it is more appropriate to calculate only the general imputed underpayment if, when calculating the specific imputed underpayment requested by the partnership, there is an increase in the number of the partnership adjustments that after grouping and netting result in net negative adjustments and are disregarded in calculating the specific imputed underpayment."

When the IRS designates a specific imputed underpayment, the IRS also has the ability to group those with adjustments that do not result in an underpayment. The regulation provides:

> If the IRS designates a specific imputed underpayment, the IRS will designate which adjustments that do not result in an imputed underpayment, if any, are appropriate to associate with that specific imputed underpayment. If the adjustments underlying that specific imputed underpayment are reallocation adjustments or

recharacterization adjustments, the net negative adjustment that resulted from the reallocation or recharacterization is associated with the specific imputed underpayment. Any adjustments that do not result in an imputed underpayment that are not associated with a specific imputed underpayment under this paragraph (g)(2)(iii)(B) are associated with the general imputed underpayment.

The IRS gives 12 examples in the final regulations (six in the proposed regulations) to illustrate these various issues with the imputed underpayment. We do not include all of the regulations. The regulations note that, for purposes of these examples, each partnership is assumed to be subject to CPAR, all of the partners are U.S. persons, the highest rate of tax is 40%, and no partnership requests a modification of the imputed underpayment.

EXAMPLE 1

Partnership reports on its 2019 partnership return $100 of ordinary income and an ordinary deduction of -$70. The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year and determines that ordinary income was $105 instead of $100 ($5 adjustment) and that the ordinary deduction was -$80 instead of -$70 ($10 adjustment). Pursuant to paragraph (c) of this section, the adjustments are both in the residual grouping. The -$10 adjustment to the ordinary deduction would not have been netted at the partnership level with the $5 adjustment to ordinary income and would not have been required to be allocated to the partners of the partnership as a single partnership-related item for purposes of Section 702(a), other provision of the Code, regulations, forms, instructions, or other guidance prescribed by the IRS. Because the -$10 adjustment to the ordinary deduction would result in a decrease in the imputed underpayment if netted with the $5 adjustment to ordinary income and because it might be limited if taken into account by any person, the -$10 adjustment must be placed in a separate subgrouping from the $5 adjustment to ordinary income. See paragraph (d)(3)(i) of this section. The total netted partnership adjustment is $5, which results in an imputed underpayment of $2. The -$10 adjustment to the ordinary deduction is a net negative amount and is an adjustment that does not result in an imputed underpayment which is taken into account by Partnership in the adjustment year in accordance with Section 301.6225–3.

EXAMPLE 2

The facts are the same as Example 1 in paragraph (h)(1) of this section, except that the -$10 adjustment to the ordinary deduction would have been netted at the partnership level with the $5 adjustment to ordinary income and would have been required to be allocated to the partners of the partnership as a single partnership-related item for purposes of Section 702(a), other provision of the Code, regulations, forms, instructions, or other guidance prescribed by the IRS. Therefore, the $5 adjustment and the -$10 adjustment must be placed in the same subgrouping within the residual grouping. The $5 adjustment and the -$10 adjustment are then netted in accordance with paragraph (e) of this section. Such netting results in a net negative adjustment (as defined under paragraph (e)(4)(ii) of this section) of -$5. Pursuant to paragraph (f) of this section, the -$5 net negative adjustment is an adjustment that does not result in an imputed underpayment. Because the only net adjustment is an adjustment that does not result in an imputed underpayment, there is no imputed underpayment.

EXAMPLE 3

Partnership reports on its 2019 partnership return ordinary income of $300, long-term capital gain of $125, long-term capital loss of -$75, a depreciation deduction of -$100, and a tax credit that can be claimed by the partnership of $5. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines that ordinary income is $500 ($200 adjustment), long-term capital gain is $200 ($75 adjustment), long-term capital loss is -$25 ($50 adjustment), the depreciation deduction is -$70 ($30

adjustment), and the tax credit is $3 ($2 adjustment). Pursuant to paragraph (c) of this section, the adjustment to the tax credit is in the credit grouping under paragraph (c)(3) of this section. The remaining adjustments are part of the residual grouping under paragraph (c)(5) of this section. Pursuant to paragraph (d)(2) of this section, all of the adjustments in the residual grouping are positive adjustments. Because there are no negative adjustments, there are no subgroupings within the residual grouping. Under paragraph (b)(2) of this section, the adjustments in the residual grouping are summed for a total netted partnership adjustment of $355. Under paragraph (b)(1)(iv) of this section, the total netted partnership adjustment is multiplied by 40% (highest tax rate in effect), which results in $142. Under paragraph (b)(1)(v) of this section, the $142 is increased by the $2 credit adjustment, resulting in an imputed underpayment of $144.

EXAMPLE 4

Partnership reported on its 2019 partnership return long-term capital gain of $125. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines the long-term capital gain should have been reported as ordinary income of $125. There are no other adjustments for the 2019 taxable year. This recharacterization adjustment results in two adjustments in the residual grouping pursuant to paragraph (c)(6) of this section: an increase in ordinary income of $125 ($125 adjustment) as well as a decrease of long-term capital gain of $125 (-$125 adjustment). The decrease in long-term capital gain is a negative adjustment under paragraph (d)(2)(ii) of this section and the increase in ordinary income is a positive adjustment under paragraph (d)(2)(iii) of this section. Under paragraph (d)(3)(i) of this section, the adjustment to long-term capital gain is placed in a subgrouping separate from the adjustment to ordinary income because the reduction of long-term capital gain is required to be taken into account separately pursuant to Section 702(a). The $125 decrease in long-term capital gain is a net negative adjustment in the long-term capital subgrouping and, as a result, is an adjustment that does not result in an imputed underpayment under paragraph (f) of this section and is taken into account in accordance with Section 301.6225–3. The $125 increase in ordinary income results in a net positive adjustment under paragraph (e)(4)(i) of this section. Because the ordinary subgrouping is the only subgrouping resulting in a net positive adjustment, $125 is the total netted partnership adjustment under paragraph (b)(2) of this section. Under paragraph (b)(1)(iv) of this section, $125 is multiplied by 40% resulting in an imputed underpayment of $50.

EXAMPLE 5

Partnership reported a $100 deduction for certain expenses on its 2019 partnership return and an additional $100 deduction with respect to the same type of expenses on its 2020 partnership return. The IRS initiates an administrative proceeding with respect to Partnership's 2019 and 2020 taxable years and determines that Partnership reported a portion of the expenses as a deduction in 2019 that should have been taken into account in 2020. Therefore, for taxable year 2019, the IRS determines that Partnership should have reported a deduction of $75 with respect to the expenses ($25 adjustment in the 2019 residual grouping). For 2020, the IRS determines that Partnership should have reported a deduction of $125 with respect to these expenses (-$25 adjustment in the 2020 residual grouping). There are no other adjustments for the 2019 and 2020 partnership taxable years. Pursuant to paragraph (e)(2) of this section, the adjustments for 2019 and 2020 and not netted with each other. The 2019 adjustment of $25 is the only adjustment for that year and a net positive adjustment under paragraph (e)(4)(i) of this section, and therefore the total netted partnership adjustment for 2019 is $25 pursuant to paragraph (b)(2) of this section. The $25 total netted partnership adjustment is multiplied by 40% resulting in an imputed underpayment of $10 for

Partnership's 2019 taxable year. The $25 increase in the deduction for 2020, a net negative adjustment under paragraph (e)(4)(ii) of this section, is an adjustment that does not result in an imputed underpayment for that year. Therefore, there is no imputed underpayment for 2020.

EXAMPLE 6

On its partnership return for the 2020 taxable year, Partnership reported ordinary income of $100 and a capital gain of $50. Partnership had four equal partners during the 2020 tax year, all of whom were individuals. On its partnership return for the 2020 tax year, the capital gain was allocated to partner E and the ordinary income was allocated to all partners based on their interests in Partnership. In an administrative proceeding with respect to Partnership's 2020 taxable year, the IRS determines that for 2020 the capital gain allocated to E should have been $75 instead of $50 and that Partnership should have recognized an additional $10 in ordinary income. In the NOPPA mailed by the IRS, the IRS may determine pursuant to paragraph (g) of this section that there is a general imputed underpayment with respect to the increase in ordinary income and a specific imputed underpayment with respect to the increase in capital gain specially allocated to E.

EXAMPLE 7

On its partnership return for the 2020 taxable year, Partnership reported a recourse liability of $100. During an administrative proceeding with respect to Partnership's 2020 taxable year, the IRS determines that the $100 recourse liability should have been reported as a $100 nonrecourse liability. Under paragraph (d)(2)(iii)(B) of this section, the adjustment to the character of the liability is an adjustment to an item that cannot be allocated under Section 704(b). The adjustment therefore is treated as a $100 increase in income because such recharacterization of a liability could result in up to $100 in taxable income if taken into account by any person. The $100 increase in income is a positive adjustment in the residual grouping under paragraph (c)(5)(ii) of this section. There are no other adjustments for the 2020 partnership taxable year. The $100 positive adjustment is treated as a net positive adjustment under paragraph (e)(4)(i) of this section, and the total netted partnership adjustment under paragraph (b)(2) of this section is $100. Pursuant to paragraph (b)(1) of this section, the total netted partnership adjustment is multiplied by 40% for an imputed underpayment of $40.

EXAMPLE 8

Partnership reports on its 2019 partnership return $400 of CFTEs in the general category under Section 904(d). The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year and determines that the amount of CFTEs was $300 instead of $400 (-$100 adjustment to CFTEs). No other adjustments are made for the 2019 taxable year. The -$100 adjustment to CFTEs is placed in the creditable expenditure grouping described in paragraph (c)(4) of this section. Pursuant to paragraph (e)(3)(iii) of this section, the decrease to CFTEs in the creditable expenditure grouping is treated as a positive adjustment to (decrease in) credits in the credit grouping under paragraph (c)(3) of this section. Because no other adjustments have been made, the $100 decrease in credits produces an imputed underpayment of $100 under paragraph (b)(1) of this section.

EXAMPLE 9

Partnership reports on its 2019 partnership return $400 of CFTEs in the passive category under Section 904(d). The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year and determines that the CFTEs reported by Partnership were general category instead of passive category

CFTEs. No other adjustments are made. Under the rules in paragraph (c)(6) of this section, an adjustment to the category of a CFTE is treated as two separate adjustments: an increase to general category CFTEs of $400 and a decrease to passive category CFTEs of $400. Both adjustments are included in the creditable expenditure grouping under paragraph (c)(4) of this section, but they are included in separate subgroupings. Therefore, the two amounts do not net. Instead, the $400 increase to CFTEs in the general category subgrouping is treated as a net negative adjustment under paragraph (e)(3)(iii)(A) of this section and is an adjustment that does not result in an imputed underpayment under paragraph (f) of this section. The decrease to CFTEs in the passive category subgrouping of the creditable expenditure grouping results in a decrease in CFTEs. Therefore, pursuant to paragraph (e)(3)(iii)(A) of this section, it is treated as a positive adjustment to (decrease in) credits in the credit grouping under paragraph (c)(3) of this section, which results in an imputed underpayment of $400 under paragraph (b)(1) of this section.

EXAMPLE 10

Partnership has two partners, A and B. Under the partnership agreement, $100 of the CFTE is specially allocated to A for the 2019 taxable year. The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year and determines that $100 of CFTE should be reallocated from A to B. Because the adjustment reallocates a creditable expenditure, paragraph (c)(4) of this section provides that it is included in the creditable expenditure grouping rather than the reallocation grouping. The partnership adjustment is a -$100 adjustment to general category CFTE allocable to A and an increase of $100 to general category CFTE allocable to B. Pursuant to paragraph (d)(3)(iii) of this section, the -$100 adjustment to general category CFTE and the increase of $100 to general category CFTE are included in separate subgroupings in the creditable expenditure grouping. The $100 increase in general category CFTEs, B-allocation subgrouping, is a net negative adjustment, which does not result in an imputed underpayment and is therefore taken into account by the partnership in the adjustment year in accordance with Section 301.6225-3. The net decrease to CFTEs in the general category, A-allocation subgrouping, is treated as a positive adjustment to (decrease in) credits in the credit grouping under paragraph (c)(3) of this section, resulting in an imputed underpayment of $100 under paragraph (b)(1) of this section.

EXAMPLE 11

Partnership has two partners, A and B. Partnership owns two entities, DE1 and DE2, that are disregarded as separate from their owner for federal income tax purposes and are operating in and paying taxes to foreign jurisdictions. The partnership agreement provides that all items from DE1 and DE2 are allocable to A and B in the following manner. Items related to DE1: to A 75% and to B 25%. Items related to DE2: to A 25% and to B 75%. On Partnership's 2018 return, Partnership reports CFTEs in the general category of $300, $100 with respect to DE1 and $200 with respect to DE2. Partnership allocates the $300 of CFTEs as $125 and $175 to A and B, respectively. During an administrative proceeding with respect to Partnership's 2018 taxable year, the IRS determines that Partnership understated the amount of creditable foreign tax paid by DE2 by $40 and overstated the amount of creditable foreign tax paid by DE1 by $80. No other adjustments are made. Because the two adjustments each relate to CFTEs that are subject to different allocations, the two adjustments are in different subgroupings under paragraph (d)(3)(iii)(B) of this section. The adjustment reducing the CFTEs related to DE1 results in a decrease in CFTEs within that subgrouping and under paragraph (e)(3)(iii)(A) of this section is treated as a decrease in credits in the credit grouping under paragraph (c)(3) of this section and results in an imputed underpayment of $80 under paragraph (b)(1) of this section. The increase of $40 of general category CFTE related to the DE2 subgrouping results in an increase in CFTEs within that subgrouping and is treated as a net negative adjustment, which does not result in an imputed underpayment and is taken into account in the adjustment year in accordance with Section 301.6225-3.

EXAMPLE 12

Partnership has two partners, A and B. For the 2019 taxable year, Partnership allocated $70 of long-term capital loss to B as well as $30 of ordinary income. In an administrative proceeding with respect to Partnership's 2019 taxable year, the IRS determines that the $30 of ordinary income and the $70 of long-term capital loss should be reallocated from B to A. The partnership adjustments are a decrease of $30 of ordinary income (-$30 adjustment) allocated to B and a corresponding increase of $30 of ordinary income ($30 adjustment) allocated to A, as well as a decrease of $70 of long-term capital loss ($70 adjustment) allocated to B and a corresponding increase of $70 of long-term capital loss (-$70 adjustment) allocated to A. See paragraph (c)(2)(ii) of this section. Pursuant to paragraph (d)(3)(ii)(A) of this section, for purposes of determining the imputed underpayment, each positive adjustment and each negative adjustment allocated to A and B is placed in its own separate subgrouping. However, notwithstanding the general requirement that reallocation adjustments be subgrouped separately, the reallocation adjustments allocated to A and B may be subgrouped in accordance with paragraph (d)(3)(i) of this section because there are two reallocation adjustments allocated to each of A and B, respectively. Pursuant to paragraph (d)(3)(i) of this section, because the partnership adjustment allocated to A would not have been netted at the partnership level and would not have been allocated to A as a single partnership-related item for purposes of section 702(a), other provisions of the Code, regulations, forms, instructions, or other guidance prescribed by the IRS, the positive adjustment and the negative adjustment allocated to A remain in separate subgroupings. For the same reasons with respect to the adjustments allocated to B, the positive adjustment and the negative adjustment allocated to B also remain in separate subgroupings. As a result, the reallocation grouping would have four subgroupings, one for each adjustment: the decrease in ordinary income allocated to B (-$30 adjustment), the increase in ordinary income allocated to A ($30 adjustment), the decrease in long-term capital loss allocated to B ($70 adjustment), and the increase long-term capital loss allocated to A (-$70 adjustment). Pursuant to paragraph (e) of this section, no netting may occur between subgroupings. Accordingly, the ordinary income allocated to A ($30 adjustment) and the long-term capital loss allocated to B ($70 adjustment) are both net positive adjustments. These net positive adjustments are added together to determine the total netted partnership adjustment of $100. The total netted partnership adjustment is multiplied by 40 percent, which results in an imputed underpayment of $40. The ordinary income allocated to B (-$30 adjustment) and the long-term capital loss allocated to A (-$70 adjustment) are net negative adjustments treated as adjustments that do not result in an imputed underpayment taken into account by the partnership pursuant to Section 301.6225-3.

Note that this was where the IRS removed an example that had been in the original proposed regulations, though without comment on why it was removed.

Modification of the Imputed Underpayment

The law allows for the partnership to present evidence to modify the imputed underpayment. The request is to be made using any forms, instructions, or other guidance the IRS may provide. Only the partnership representative may request this modification (Reg. Section 301.6225-2(a)).

Relevant Partner

The term "relevant partner" is used as part of the modification process. Where that term is used, it has the following meaning:

> . . . [T]he term *relevant partner* means any person for whom modification is requested by the partnership that is—
>
> (1) A reviewed year partner (as defined in Section 301.6241-1(a)(9)), including any pass-through partner (as defined in Section 301.6241-1(a)(5)), except for any reviewed year partner that is a wholly-owned entity disregarded as separate from its owner for Federal income tax purposes, or
>
> (2) An indirect partner (as defined in Section 301.6241-1(a)(4)) except for any indirect partner that is a wholly-owned entity disregarded as separate from its owner for Federal income tax purposes.

Effect of Modification

A modification may increase or decrease the amount of an imputed underpayment by affecting the extent to which adjustments factor into the calculation of the imputed underpayment; the tax rate that is applied in computing the imputed underpayment; and other adjustments that may be provided in forms, instructions, or other guidance issued by the IRS. (Reg. Section 301.6625-2(b)(1))

There is an order in which modifications will be applied if the partnership requests multiple modifications.

- First, modifications that affect the extent to which an adjustment factors into the calculation of imputed underpayment are taken into account.
- Second, modification of the number and composition of imputed underpayments, then
- After that, modifications that affect the tax rate are taken into account.

Modifications That Affect Partnership Adjustments

The modifications that affect partnership adjustments are as follows:

- Amended returns (governed by Reg. Section 301.6625-2(d)(2))
- Tax-exempt status (governed by Reg. Section 301.6625-2(d)(3))
- Specified passive activity losses of publicly traded partnerships (governed by Reg. Section 301.6625-2(d)(5))
- Qualified investment entities (governed by Reg. Section 301.6625-2(d)(7))
- Closing agreements (governed by Reg. Section 301.6625-2(d)(8))

- Tax treaty modifications (governed by Reg. Section 301.6625-2(d)(9))
- Other modifications (governed by Reg. Section 301.6625-2(d)(10))

If the IRS approves the adjustment taken into account under one of these provisions, it is excluded from the general computation of the imputed underpayment found at Reg. Section 301.6225-1(b) (the highest rate calculation). Instead, the total netted partnership appropriate adjustment if the imputed modification will be made for the particular adjustment or portion of the adjustment is part of the reallocation group or the residual grouping. The amount is also excluded from the credit grouping if the adjustment or a portion thereof is part of the credit grouping (Reg. Section 301.6625-2(b)(2)).

Amended Returns by Partners

The partnership may request a modification of the imputed underpayment based upon a qualifying amended return filed by a review partner that takes into account all of the partnership adjustments properly allocable to that partner. In that case, the partnership may not request an additional modification of any imputed payment for the taxable year related to the amended return partner (Reg. Section 301.6625-2(d)(2)(i)).

Merely filing an amended return is not enough—the partner must also make full payment of the tax due on the amended return. Per Reg. Section 301.6625-2(d)(2)(ii)(A):

> An amended return modification request under paragraph (d)(2) of this section will not be approved unless the relevant partner filing the amended return has paid all tax, penalties, additions to tax, additional amounts, and interest due as a result of taking into account all partnership adjustments in the first affected year (as defined in Section 301.6226-3(b)(2)) and all modification years (as described in paragraph (d)(2)(ii)(B) of this section) at the time such return is filed with the IRS.

An amended return for all relevant years must be filed as well. That includes the first affected year of any modification year.

The first affected year is the taxable year of the partner that includes the end of the reviewed year (Reg. Section 301.6226-3(b)(2)).

A modification year may be a taxable year before or after the first affected year, depending on the effect on the relevant partner's tax attributes of taking into account the relevant partner's distributive share of the partnership adjustments in the first affected year.

For modifications that reallocate distributive shares, generally all affected partners must file amended returns in order to take advantage of an amended return adjustment on the item.[162] However, the regulation provides:

> *The IRS may determine that the requirements of this paragraph (d)(2)(ii)(C) are satisfied even if not all relevant partners affected by such adjustments file amended returns provided any relevant partners affected by the reallocation not filing amended returns take into account their distributive share of the adjustments through other modifications approved by the IRS (including the alternative procedure to filing amended returns under paragraph (d)(2)(x) of this section) or if a pass-through*

[162] Reg. Section 301.6625-2(d)(2)(ii)(C)

> *partner takes into account the relevant adjustments in accordance with paragraph (d)(2)(vi) of this section.*[163]

The regulation provides examples of when the IRS would be willing to deal with not all affected partners filing amended returns:

> *For instance, in the case of adjustments that reallocate a loss from one partner to another, the IRS may determine that the requirements of this paragraph (d)(2)(ii)(C) have been satisfied if one affected relevant partner files an amended return taking into account the adjustments and the other affected relevant partner signs a closing agreement with the IRS taking into account the adjustments. Similarly, in the case of adjustment that reallocate income from one partner to another, the IRS may determine that the requirements of this paragraph (d)(2)(ii)(C) have been satisfied to the extent an affected relevant partner meets the requirements of paragraph (d)(3) of this section (regarding tax-exempt partners) and through such modification fully takes into account all adjustments reallocated to the affected relevant partner.*[164]

The form and manner for making a qualified amended return is outlined in Reg. Section 301.6225-1(d)(2)(iii).

> A relevant partner must file all amended returns required for modification under paragraph (d)(2) of this section with the IRS in accordance with forms, instructions, and other guidance prescribed by the IRS. Except as otherwise provided under the alternative procedure described in paragraph (d)(2)(x) of this section, the IRS will not approve modification under paragraph (d)(2) of this section unless prior to the expiration of the 270-day period described in paragraph (c')(3) of this section, the partnership representative provides to the IRS, in the form and manner prescribed by the IRS, an affidavit from each relevant partner signed under penalties of perjury by such partner stating that all of the amended returns required to be filed under paragraph (d)(2) of this section has been filed (including the date on which such amended returns were filed) and that the full amount of tax, penalties, additions to tax, additional amounts, and interest was paid (including the date on which such amounts were paid).

The regulations provide an exception from the statute of limitations under IRC Sections 6501 and 6511 to allow amended returns to be voluntarily filed in these cases. In the original proposed regulations, the IRS had not waived the statute, making the provision effectively unavailable unless a special closing agreement was entered into.

An indirect partner (that is, an individual or entity that is a partner in a partnership that holds an interest in the partnership under exam) can qualify for use of this modification if the partnership:

> (A) Establishes that the pass-through partner is not subject to chapter 1 tax on the adjustments that are properly allocated to such pass-through partner; or
>
> (B) Requests modification with respect to the adjustments resulting in chapter 1 tax for the pass-through partner, including full payment of such chapter 1 tax for the first affected year and all modification years under paragraph (d)(2) of this section or in accordance with forms, instructions, or other guidance prescribed by the IRS.

[163] Reg. Section 301.6625-2(d)(2)(ii)(C)

[164] Reg. Section 301.6625-2(d)(2)(ii)(C)

If one or more partners are pass-through entities, the pass-through entity may file an amended return and pay a tax equal to the safe harbor tax computed under the provisions described later in the regulations for the statements issued to partners when the adjustments are passed through under Reg. Section 301.6226-2(g). The tax will be computed in the same manner had the push out election been made per the rules found at Reg. Section 301.6226-3(e)(4)(iii).

The IRS provides the following guidance for upper tier partners:

> In accordance with forms, instructions, and other guidance provided by the IRS, for purposes of determining and calculating the amount a pass-through partner must pay under paragraph (d)(2)(vi)(A) of this section, the pass-through partner may take into account modifications with respect to its direct and indirect partners to the extent that such modifications are requested by the partnership requesting modification and approved by the IRS under this section.
>
> A partner (or indirect partner) may not file an amended return with regard to partnership adjustments except as provided for in these rules (Reg. Section 301.6225-1(d)(vii)(A)). Additionally, if a partner files an amended return under these provisions, the partner may not file another amended return for the year(s) amended without the permission of the IRS (Proposed Reg. Section 301.6225-1(d)(vii)(B)).

An exception to the "no further amendments rule" is provided by the regulations in the following special cases:

> . . . [A] relevant partner that has previously filed an amended return under paragraph (d)(2) of this section, or satisfied the requirements of paragraph (d)(2) of this section through the alternative procedure, to take partnership adjustments into account may, in accordance with forms, instructions, and other guidance prescribed by the IRS, file a subsequent return or claim for refund if a determination is made by a court or by the IRS that results in a change to the partnership adjustments taken into account in modification under paragraph (d)(2) of this section or a denial of modification by the IRS, under paragraph (c)(2)(i) of this section with respect to a modification request under paragraph (d)(2) of this section. Such determinations include a court decision that changes the partnership adjustments for which modification was requested or a settlement between the IRS and the partnership pursuant to which the partnership is not liable for all or a portion of the imputed underpayment for which modification was requested. Any amended return or claim for refund filed under this paragraph (d)(2)(vii) is subject to the period of limitations under Section 6511.

Tax-Exempt Partners

The partnership can also request a modification to the extent that it can show the adjustment would be properly allocable to a partner that was tax exempt in the reviewed year under Reg. Section 301.6225-2(d)(3).

The regulation defines a "tax-exempt entity" by reference to IRC Sections 168(h)(2)(A), (C), or (D) (Reg. Section 301.6225-2(d)(3)(ii)). Thus, the list of tax-exempt partners would include:

- the United States, any state or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing;

- an organization (other than a cooperative described in Section 521) that is exempt from tax imposed by this chapter;
- any foreign person or entity; and
- any Indian tribal government described in Section 7701(a)(40) (IRC Section 168(h)(2)(A)).

A "foreign person or entity" for this purpose is defined as:

- any foreign government, any international organization, or any agency or instrumentality of any of the foregoing; and
- any person who is not a United States person.

However, the term does not include any foreign partnership or other foreign pass-through entity (IRC Section 168(h)(2)(C)).

Excluded from the list of tax-exempt entities are certain instrumentalities of a government that are taxable. An instrumentality is excluded if:

- all of the activities of such corporation are subject to tax under this chapter, and
- a majority of the board of directors of such corporation is not selected by the United States or any state or political subdivision thereof. (IRC Section 168(h)(2)(D))

The regulation provides the following details with regard to a modification under this provision:

> Only the portion of the partnership adjustments properly allocated to a tax-exempt partner with respect to which the partner would not be subject to tax for the reviewed year (tax- exempt portion) may form the basis of a modification of the imputed underpayment under paragraph (d)(3) of this section. A modification under paragraph (d)(3) of this section will not be approved by the IRS unless the partnership provides documentation in accordance with paragraph (c)(2) of this section to support the tax-exempt partner's status and the tax- exempt portion of the partnership adjustment allocable to the tax-exempt partner.
> (Reg. Section 301.6225-2(d)(3)(iii))

Specified Passive Activity Losses of Publicly Traded Partnerships

Regulation Section 301.6225-2(d)(5) allows for a publicly traded partnership (as defined in IRC Section 469(k)(2)) to remove from the calculation of the imputed underpayment amounts related to "specified passive activity losses." The imputed underpayment is determined:

- Without regard to any adjustment that would be reduced by a specified passive activity loss;
- Which is allocable to
  - A specified partner or
  - Qualified relevant partner.

A specified passive activity loss is defined at Reg. Section 301.6225-2(d)(5)(ii).

> A specified passive activity loss carryover amount for any specified partner or qualified relevant partner of a publicly traded partnership is the lesser of the Section 469(k) passive activity loss of that partner which is separately determined with respect to such partnership—
>
> (A) at the end of the first affected year loss; or
>
> (B) at the end of—
>
> > (1) The specified partner's taxable year in which or with which the adjustment year (as defined in Section 301.6241–1(a)(1)) of the partnership ends, reduced to the extent any such partner has utilized any portion of its affected year loss to offset income or gain relating to the ownership or disposition of its interest in such publicly traded partnership during either the adjustment year or any other year; or
> >
> > (2) If the adjustment year has not yet been determined, the most recent year for which the publicly traded partnership has filed a return under Section 6031, reduced to the extent any such partner has utilized any portion of its affected year loss to offset income or gain relating to the ownership or disposition of its interest in such publicly traded partnership during any year.

The adjustment is limited to specified passive losses allocated to specified partners.

> "A specified partner is a person that for each taxable year beginning with the first affected year through the person's taxable year in which or with which the partnership adjustment year ends satisfies the following three requirements—
> (A) The person is a partner of the publicly traded partnership requesting modification under this section; (B) The person is an individual, estate, trust, closely held C corporation, or personal service corporation; and (C) The person has a specified passive activity loss with respect to the publicly traded partnership." (Regs. Section 301.6225-2(d)(5)(iii))

When this modification is made, a notification must be made to the partner that he is required to reduce his suspended passive loss carryover.

Qualified Investment Entities Adjustment

A special adjustment is available for partnerships with partners who are "qualified investment entities" as described in IRC Section 860(b). Per Reg. Section 301.6225-2(d)(7)(i):

> "A partnership may request a modification of an imputed underpayment based on the partnership adjustments allocated to a relevant partner where the modification is based on deficiency dividends distributed as described in Section 860(f) by a relevant partner that is a qualified investment entity (QIE) under Section 860(b) (which includes both a regulated investment company (RIC) and a real estate investment trust (REIT)). Modification under paragraph (d)(7) of this section is available only to the extent that the deficiency dividends take into account adjustments described in Section 301.6225–1 that are also adjustments within the meaning of Section 860(d)(1) or (d)(2) (whichever applies)."

Regulation Section 301.6225-2(d)(7)(ii) provides the following requirements with regard to the documentation of the deficiency dividend:

> The partnership must provide documentation in accordance with paragraph (c) of this section of the "determination" described in Section 860(e). Under Section 860(e) (2), Section 1.860-2(b)(1)(i) of this chapter, and paragraph (d)(8) of this section, a closing agreement entered into by the QIE partner pursuant to Section 7121 and paragraph (d)(8) of this section is a determination described in Section 860(e), and the date of the determination is the date in which the closing agreement is approved by the IRS. In addition, under Section 860(e)(4), a determination also includes a Form 8927, Determination Under Section 860(e)(4) by a Qualified Investment Entity, properly completed and filed by the RIC or REIT pursuant to Section 860(e)(4). To establish the date of the determination under Section 860(e)(4) and the amount of deficiency dividends actually paid, the partnership must provide a copy of Form 976, Claim for Deficiency Dividends Deductions by a Personal Holding Company, Regulated Investment Company, or Real Estate Investment Trust (Form 976), properly completed by or on behalf of the QIE pursuant to Section 860(g), together with a copy of each of the required attachments for Form 976.

Closing Agreements

Under Reg. Section 301.6225-2(d)(8), the partnership can request an adjustment based on a closing agreement entered into by a partner with the IRS. The regulation provides:

> A partnership may request modification based on a closing agreement entered into by the IRS and the partnership or any relevant partner, or both if appropriate, pursuant to Section 7121. If modification under this paragraph (d)(8) is approved by the IRS, any partnership adjustment that is taken into account under such closing agreement and for which any required payment under the closing agreement is made will not be taken into account in determining the imputed underpayment under Section 301.6225–1. Any required payment under the closing agreement may include amounts of tax, including tax under chapters other than chapter 1, interest, penalties, additions to tax and additional amounts. Generally, the IRS will not approve any additional modification under this section with respect to a relevant partner to which a modification under this paragraph (d)(8) has been approved.

Tax Treaty Modifications

The partnership can request modifications to be made to take into account tax treaty issues. Regulation Section 301.6625-1(d)(9) provides:

> A partnership may request a modification under this paragraph (d)(9) with respect to a relevant partner's distributive share of an adjustment to a partnership-related item if, in the reviewed year, the relevant partner was a foreign person who qualified under an income tax treaty with the United States for a reduction or exemption from tax with respect to such partnership-related item. A partnership requesting modification under this section may also request a treaty modification under this paragraph (d)(9) regardless of the treaty status of its partners if, in the reviewed year, the partnership itself was an entity eligible for such treaty benefits.

Other Modifications

The regulations include a final wildcard category in which a partnership can request an adjustment for reasons not covered directly in the regulations. Regulation Section 301.6225-2(d)(10) provides:

> A partnership may request a modification not otherwise described in paragraph (d) of this section and the IRS will determine whether such modification is accurate and appropriate in accordance with paragraph (c)(4) of this section. Additional types of modifications and the documentation necessary to substantiate such modifications may be set forth in forms, instructions, or other guidance prescribed by the IRS.

Modification of the Number & Composition of Imputed Underpayments

The partnership can also make a request to modify groupings and subgroupings of adjustments per Reg. Section 301.6225-2(d)(6).

The regulation provides:

> (i) In general. A partnership may request modification of the number or composition of any imputed underpayment included in the NOPPA by requesting that the IRS include one or more partnership adjustments in a particular grouping or subgrouping (as described in Section 301.6225–1(c) and (d)) or specific imputed underpayments (as described in Section 301.6225–1(g)) different from the grouping, subgrouping, or imputed underpayment set forth in the NOPPA. For example, a partnership may request under paragraph (d)(6) of this section that one or more partnership adjustments taken into account to determine a general imputed underpayment set forth in the NOPPA be taken into account to determine a specific imputed underpayment.
>
> (ii) Request for particular treatment regarding limitations or restrictions. A modification request under paragraph (d)(6) of this section includes a request that one or more partnership adjustments be treated as if no limitations or restrictions under Section 301.6225–1(d) apply and as a result such adjustments may be subgrouped with other adjustments.

Modification Based on a Lower Tax Rate

After the modifications related to the amount of the adjustments are taken into account, the taxpayer can present evidence in certain cases that indicates a rate lower than the maximum tax rate should apply to some or all of the adjustments remaining.

Regulation Section 301.6225-2(d)(4) provides the provisions for the modification of the rate. The regulation allows two types of rate adjustments:

- Adjustments that are attributable to a relevant partner that is a C corporation
- Adjustments with respect to capital gains or qualified dividends that are attributable to a relevant partner who is an individual or an S corporation

The adjustment does not look at the actual marginal rate of the taxpayer(s) in question for the income, but rather at the maximum rate of tax on such income for such taxpayers.

The adjustment is also strictly limited to the two categories of taxpayers named in the law. Specifically, adjustments with respect to trusts or estates for adjustments with respect to capital gains or qualified dividends do not qualify for an adjustment to a lower rate.

The regulation provides an illustration of how this would impact both C and S corporations:

> For instance, with respect to adjustments that are attributable to a C corporation, the highest rate in effect for the reviewed year with respect to all C corporations would apply to that adjustment, regardless of the rate that would apply to the C corporation based on the amount of that C corporation's taxable income. For purposes of this paragraph (d)(4), an S corporation is treated as an individual.

Examples of the Adjustments

The IRS provides eight examples in the regulations (six in the proposed regulations) of the application of the modification provisions. For purposes of the examples, it is assumed that the partnership and its partners are all calendar year taxpayers, all partners are U.S. persons unless otherwise stated, the highest rate of tax in effect is 40%, and the partnerships request no adjustments other than those named in the examples.

The examples include discussion of unrelated business taxable income. We note the IRS issued proposed regulations on April 24, 2020, clarifying how tax-exempt organizations are to calculate unrelated business taxable income from separate trades or businesses. Sources of UBTI include income flowing through partnerships (85 FR 23172, Reg-106864-18).

EXAMPLE 1

Partnership has two partners during its 2019 partnership taxable year: P and S. P is a partnership, and S is an S corporation. P has four partners during its 2019 partnership taxable year: A, C, T, and DE. A is an individual, C is a C corporation, T is a trust, and DE is a wholly-owned entity disregarded as separate from its owner for federal income tax purposes. The owner of DE is B, an individual. T has two beneficiaries during its 2019 taxable year: F and G, both individuals. S has 3 shareholders during its 2019 taxable year: H, J, and K, all individuals. For purposes of this section, if Partnership requests modification with respect to A, B, C, F, G, H, J, and K, those persons are all relevant partners (as defined in paragraph (a) of this section). P, S, and DE are not relevant partners (as defined in paragraph (a) of this section) because DE is a wholly-owned entity disregarded as separate from its owner for federal income tax purposes and modification was not requested with respect to P and S.

EXAMPLE 2

The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year. The IRS mails a NOPPA to Partnership for the 2019 partnership taxable year proposing a single partnership adjustment increasing ordinary income by $100, resulting in a $40 imputed underpayment ($100 multiplied by the 40% tax rate). Partner A, an individual, held a 20% interest in Partnership during 2019. Partnership timely requests modification under paragraph (d)(2) of this section based on A's filing an amended return for the 2019 taxable year taking into account $20 of the partnership adjustment and paying the tax and interest due attributable to A's share of the increased income and the tax rate applicable to A for the 2019 tax year. No tax attribute in any other taxable year of A is affected by A's taking into account A's share of the partnership adjustment for 2019. In accordance with paragraph (d)(2)(iii) of this section, Partnership's partnership representative provides the IRS with documentation demonstrating that A filed the 2019 return and paid all tax and interest due. The IRS approves the modification and, in accordance with paragraph

(b)(2) of this section, the $20 increase in ordinary income allocable to A is not included in the calculation of the total netted partnership adjustment (determined in accordance with Section 301.6225–1). Partnership's total netted partnership adjustment is reduced to $80 ($100 adjustment less $20 taken into account by A), and the imputed underpayment is reduced to $32 (total netted partnership adjustment of $80 after modification multiplied by 40%).

EXAMPLE 3

The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year. Partnership has two equal partners during its entire 2019 taxable year: an individual, A, and a partnership-partner, B. During all of 2019, B has two equal partners: a tax-exempt entity, C, and an individual, D. The IRS mails a NOPPA to Partnership for its 2019 taxable year proposing a single partnership adjustment increasing Partnership's ordinary income by $100, resulting in a $40 imputed underpayment ($100 total netted partnership adjustment multiplied by 40%). Partnership timely requests modification under paragraph (d)(3) of this section with respect to B's partner, C, a tax-exempt entity. In accordance with paragraph (d)(3)(iii) of this section, Partnership's partnership representative provides the IRS with documentation substantiating to the IRS's satisfaction that C held a 25% indirect interest in Partnership through its interest in B during the 2019 taxable year, that C was a tax-exempt entity defined in paragraph (d)(3)(ii) of this section during the 2019 taxable year, and that C was not subject to tax with respect to its entire allocable share of the partnership adjustment allocated to B (which is $25 (50% × 50% × $100)). The IRS approves the modification and, in accordance with paragraph (b)(2) of this section, the $25 increase in ordinary income allocated to C, through B, is not included in the calculation of the total netted partnership adjustment (determined in accordance with Section 301.6225–1). Partnership's total netted partnership adjustment is reduced to $75 ($100 adjustment less C's share of the adjustment, $25), and the imputed underpayment is reduced to $30 (total netted partnership adjustment of $75, after modification, multiplied by 40%).

EXAMPLE 4

The facts are the same as in Example 3 in paragraph (f)(3) of this section, except $10 of the $25 of the adjustment allocated to C is unrelated business taxable income (UBTI) as defined in Section 512 because it is debt-financed income within the meaning of Section 514 (no Section 512 UBTI modifications apply) with respect to which C would be subject to tax if taken into account by C. As a result, the modification under paragraph (d)(3) of this section with respect to C relates only to $15 of the $25 of ordinary income allocated to C that is not UBTI. Therefore, only a modification of $15 ($25 less $10) of the total $100 partnership adjustment may be approved by the IRS under paragraph (d)(3) of this section and, in accordance with paragraph (b)(2) of this section, excluded when determining the imputed underpayment for Partnership's 2019 taxable year. The total netted partnership adjustment (determined in accordance with Section 301.6225–1) is reduced to $85 ($100 less $15), and the imputed underpayment is reduced to $34 (total netted partnership adjustment of $85, after modification, multiplied by 40%).

EXAMPLE 5

The facts are the same as in Example 3 in paragraph (f)(3) of this section, except that Partnership also timely requests modification under paragraph (d)(2) of this section with respect to an amended return filed by B, and, in accordance with (d)(2)(iii) of this section, Partnership's partnership representative provides the IRS with documentation demonstrating that B filed the 2019 return and paid all tax and interest due. B reports 50% of the partnership adjustments ($50) on its amended return, and B calculates an amount under paragraph (d)(2)(vi)(A) of this section and Section 301.6226–3(e)(4)(iii) that, pursuant to paragraph (d)(2)(vi)(B) of this section, takes into account the modification under paragraph (d)(3) of this section

approved by the IRS with respect to B's partner C, a tax-exempt entity. B makes a payment pursuant to paragraph (d)(2)(ii)(A) of this section, and the IRS approves the requested modification. Partnership's total netted partnership adjustment is reduced by $50 (the amount taken into account by B). Partnership's total netted partnership adjustment (determined in accordance with Section 301.6225–1) is $50, and the imputed underpayment, after modification, is $20.

EXAMPLE 6

The facts are the same as in Example 3 in paragraph (f)(3) of this section, except that in addition to the modification with respect to tax-exempt entity C, which reduced the imputed underpayment by excluding from the determination of the imputed underpayment $25 of the $100 partnership adjustment reflected in the NOPPA, Partnership timely requests modification under paragraph (d)(2) of this section with respect to an amended return filed by individual D, and, in accordance with paragraph (d)(2)(iii) of this section, Partnership's partnership representative provides the IRS with documentation demonstrating that D filed the 2019 return and paid all tax and interest due. D's amended return for D's 2019 taxable year takes into account D's share of the partnership adjustment (50% of B's 50% interest in Partnership, or $25) and D paid the tax and interest due as a result of taking into account D's share of the partnership adjustment in accordance with paragraph (d)(2) of this section. No tax attribute in any other taxable year of D is affected by D taking into account D's share of the partnership adjustment for 2019. The IRS approves the modification and the $25 increase in ordinary income allocable to D is not included in the calculation of the total netted partnership adjustment (determined in accordance with Section 301.6225–1). As a result, Partnership's total netted partnership adjustment is $50 ($100, less $25 allocable to C, less $25 taken into account by D), and the imputed underpayment, after modification, is $20.

EXAMPLE 7

The IRS initiates an administrative proceeding with respect to Partnership's 2019 taxable year. All of Partnership's partners during its 2019 taxable year are individuals. The IRS mails a NOPPA to Partnership for the 2019 taxable year proposing three partnership adjustments. The first partnership adjustment is an increase to ordinary income of $75 for 2019. The second partnership adjustment is an increase in the depreciation deduction allowed for 2019 of $25, which under Section 301.6225–1(d)(2)(i) is treated as a $25 decrease in income. The third adjustment is an increase in long-term capital gain of $10 for 2019. Under the partnership agreement in effect for Partnership's 2019 taxable year, the long-term capital gain and the increase in depreciation would be specially allocated to B and the increase in ordinary income would be specially allocated to A. In accordance with Section 301.6225–1(c) and (d), the three adjustments are placed into three separate subgroupings within the residual grouping because the partnership adjustments would not have been netted at the partnership level and would not have been required to be allocated to the partners of the partnership as a single, net partnership-related item for purposes of Section 702(a), other provisions of the Code, regulations, forms, instructions, or other guidance prescribed by the IRS. Accordingly, the total netted partnership adjustment is $85 ($75 net positive adjustment to ordinary income plus $10 net positive adjustment to long-term capital gain), and the imputed underpayment is $34 ($85 multiplied by 40%). The net negative adjustment to depreciation is an adjustment that does not result in an imputed underpayment subject to treatment under Section 301.6225–3. Partnership requests a modification under paragraph (d)(6) of this section to determine a specific imputed underpayment with respect to the $75 adjustment to ordinary income allocated to A. The specific imputed underpayment is with respect to $75 of the increase in income specially allocated to A and the general imputed underpayment is with respect to $10 of the increase in capital gain and the $25 increase in depreciation deduction specially allocated to B. If the modification is approved by the IRS, the specific imputed underpayment would consist of the $75 increase in ordinary income, and thus the total netted partnership adjustment for the specific imputed underpayment would be $75. The specific imputed underpayment is

thus $30 ($75 multiplied by 40%). The general imputed underpayment would consist of two adjustments: The long-term capital gain adjustment and the depreciation adjustment. The long-term capital gain adjustment and the depreciation adjustment would be placed in different subgroupings under Section 301.6225–1(d) because they are treated separately under Section 702. Accordingly, the long-term capital gain adjustment and the depreciation adjustment are not netted, and the long-term capital gain adjustment would be a net positive adjustment while the depreciation adjustment would be a net negative adjustment. The long-term capital gain net positive adjustment would be the only net positive adjustment, resulting in a total netted partnership adjustment of $10. The general imputed underpayment is $4 ($10 multiplied by 40%), and the net negative adjustment to depreciation of $25 would be an adjustment that does not result in an imputed underpayment under Section 301.6225–1(f) associated with the general imputed underpayment.

EXAMPLE 8

Partnership has two reviewed year partners, C1 and C2, both of which are C corporations. The IRS mails to Partnership a NOPPA with two adjustments, both based on rental real estate activity. The first adjustment is an increase of rental real estate income of $100 attributable to Property A. The second adjustment is an increase of rental real estate loss of $30 attributable to Property B. The Partnership did not treat the leasing arrangement with respect to Property A and Property B as an appropriate economic unit for purposes of Section 469. If the $100 increase in income attributable to Property A and the $30 increase in loss attributable to Property B were included in the same subgrouping and netted, then taking the $30 increase in loss into account would result in a decrease in the amount of the imputed underpayment. Also, the $30 increased loss might be limited or restricted if taken into account by any person under the passive activity rules under Section 469. For instance, under Section 469, rental activities of the two properties could be treated as two activities, which could limit a partner's ability to claim the loss. In addition to the potential limitations under Section 469, there are other potential limitations that might apply if the $30 loss were taken into account by any person. Therefore, in accordance with Section 301.6225–1(d), the two adjustments are placed in separate subgroupings within the residual grouping, the total netted partnership adjustment is $100, the imputed underpayment is $40 ($100 × 40%), and the $30 increase in loss is an adjustment that does not result in an imputed underpayment under Section 301.6225–1(f). Partnership requests modification under paragraph (d)(6) of this section, substantiating to the satisfaction of the IRS that C1 and C2 are publicly traded C corporations, and therefore, the passive activity loss limitations under Section 469 of the Code do not apply. Partnership also substantiates to the satisfaction of the IRS that no other limitation or restriction applies that would prevent the grouping of the $100 with the $30 loss. The IRS approves Partnership's modification request and places the $100 of income and the $30 loss into the subgrouping in the residual grouping under the rules described in Section 301.6225–1(c)(5). Under Section 301.6225–1(e), because the two adjustments are in one subgrouping, they are netted together, resulting in a total netted partnership adjustment of $70 ($100 plus $30) and an imputed underpayment of $28 ($70 × 40%). After modification, none of the adjustments is an adjustment that does not result in an imputed underpayment under Section 301.6225–1(f) because the $30 loss is now netted with the $100 of income in a net positive adjustment for the residual grouping.

Adjustments to Partners' Outside Bases & Capital Accounts & a Partnership's Basis & Book Value in Property

The IRS did not publish proposed regulations dealing with adjustments to partners' outside bases and capital accounts and a partnership's basis and book value in property, instead marking that area as reserved (Proposed Reg. Section 301.6225-4).

In the preamble to the proposed regulations, the IRS notes:

> [p]roviding mechanical rules to govern the adjustments to adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property raise a myriad of technical issues on which the Treasury Department and the IRS request comments. As a result, the proposed regulations reserve a place for rules regarding adjustments to a partner's outside basis or capital account and a partnership's basis or book value in property when a partnership elects the application of Section 6226 with respect to an imputed underpayment.

But that doesn't mean the IRS doesn't have some ideas on how to approach the problem. In the preamble, the IRS first notes:

> [t]he Treasury Department and the IRS have determined that, in the adjustment year, adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property should be adjusted to what they would have been if the adjustments were made in the reviewed year to reviewed year partners and property and then modified to take into account all intervening events considered in computing the amount by which the tax imposed under chapter 1 would increase for any intervening year—for example, amortization or depreciation of property. In some cases, the reviewed year partner may not be an adjustment year partner, or the partnership might, in an intervening year, have disposed of property to which an adjustment relates. Accordingly, rules will also need to provide how adjustments to adjustment year partners' outside bases and capital accounts and a partnership's basis and book value in property are made when there have been: (1) sales of property, (2) distributions of property to partners, (3) contributions of property to corporations or lower-tier partnerships, (4) other nonrecognition transfers of property, (5) sales of partnership interests, (6) transfers of partnership interests in nonrecognition transactions, and (7) contributions to the partnership. In addition, the Treasury Department and the IRS are considering whether partnerships should be required to recompute basis adjustments under Sections 734 and 743 that resulted from distributions or transfers in intervening years to take into account adjustments to partners' outside bases and a partnership's basis in property. The Treasury Department and the IRS are also considering whether and how an adjustment should be made to the basis of property distributed in an intervening year when an adjustment to the partnership's basis in that property or an adjustment to the recipient partner's outside basis would otherwise have been appropriate.

It seems appropriate that any outside basis and capital account adjustments that need to be made are made with respect to the adjustment year partners who are the reviewed year partners who received a statement of the partner's share of any adjustment to income, gain, loss, deduction or credit. The Treasury Department and the IRS believe that if a reviewed year partner transfers its partnership interest in an intervening year, it is appropriate for the transferee adjustment year partner's capital account and outside basis to be adjusted in the adjustment year. Whether the interest was transferred in a recognition transaction or a nonrecognition transaction, however, is relevant to the amount of the adjustment to the transferee's outside basis, but not capital account, because the transferee in either case succeeds to the capital account of the transferor, however, in a recognition transaction, the transferee would have taken a cost basis in the interest upon a transfer in which gain was recognized. The Treasury Department and the IRS request comments regarding whether and how to adjust the outside bases and capital accounts of adjustment year partners if the reviewed year partner whose basis and capital account should have been adjusted is no longer a partner as a result of a

liquidating distribution and thus no other partner has succeeded to the liquidating partner's capital account.

The IRS adds one final request in the preamble.

> Finally, comments are requested on how, or if, these regulations should address partnerships that do not maintain capital accounts.

The final regulations maintain the IRS's silence in this area.

Election for an Alternative to the Payment of the Imputed Adjustment (the "Push-Out" Option)

The CPAR offers an option for the partnership to avoid paying the imputed underpayment by "pushing out" the adjustments to those who were partners in the reviewed year under the provisions of IRC Section 6226.

The regulations clarify that the election is not an "all or nothing" election. As is noted in Regulation Section 301.6226-1(a):

> If a notice of final partnership adjustment (FPA) mailed under Section 6231 includes more than one imputed underpayment in accordance with Section 301.6225-1(g), a partnership may make an election under this section with respect to one or more imputed underpayments included in the FPA.

The effect of this election on the reviewed year partners is described in Reg. Section 301.6226-1(b)(1).

> If a partnership makes a valid election under this section with respect to any imputed underpayment, the reviewed year partners (as defined in Section 301.6241-1(a) (9)) must take into account their share of the partnership adjustments (as defined in Section 301.6241–1(a)(6)) that are associated with that imputed underpayment and are liable for any tax, penalties, additions to tax, additional amounts, and interest as described in Section 301.6226–3. See Section 301.6226–2(f) regarding the determination of each reviewed year partner's share of the partnership adjustments, including the effect of any modification approved by the Internal Revenue Service (IRS) under Section 301.6225–2.

The effect of the election on the partnership is outlined in Reg. Section 301.6226-1(b)(2).

> A partnership making a valid election under this section is not liable for the imputed underpayment to which the election applies (and no assessment of tax, levy, or proceeding in any court for the collection of such imputed underpayment may be made against such partnership). Any adjustments that do not result in an imputed underpayment described in Section 301.6225–1(f) that are associated with an imputed underpayment (as described in Section 301.6225–1(g)) for which an election under this section is made are not taken into account by the partnership in the adjustment year (as defined in Section 301.6241–1(a)(1)) and instead each reviewed year partner's share of the adjustments determined in accordance with Section 301.6226–2(f) must be included on the statement described in Section 301.6226–2.

For a "push-out" election to be valid, all of the provisions of Reg. Sections 301.6626-1 and 301.6626-2 regarding statements to be provided to partners and the IRS must be satisfied. Once the election is made, it can only be revoked with the consent of the IRS (Reg. Section 301.6226-1(c)(1)).

The election is valid until and unless the IRS determines the election is invalid. If the IRS determines an election is invalid, the IRS will notify the partnership and partnership representative of this fact within 30 days of the date the election is determined to be invalid, along with the reason it is invalid (Reg. Section 301.6226-1(d)). The regulation provides:

> If the IRS makes a final determination that an election under this section is invalid, Section 6225 applies with respect to the imputed underpayment as if the election was never made, the IRS may assess the imputed underpayment against the partnership (without regard to the limitations under Section 6232(b)), and the partnership must pay the imputed underpayment under Section 6225 and any penalties and interest under Section 6233. The IRS may not determine that an election is invalid based on errors timely corrected by the partnership in accordance with Section 301.6226–2(d).
> (Reg. Section 301.6226-1(d))

The election must be filed within 45 days of the date the FPA is mailed by the IRS, and there are no extensions allowed (Reg. Section 301.6226-1(c)(2)).

The election must be signed by the partnership representative and filed in accordance with the forms, instructions and other guidance provided by the IRS. The election must also include:

A) [t]he name, address, and correct taxpayer identification number (TIN) of the partnership,

B) [t]he taxable year to which the election relates,

C) [a] copy of the FPA to which the election relates,

D) [i]n the case of an FPA that includes more than one imputed underpayment, identification of the imputed underpayment(s) to which the election applies,

E) [e]ach reviewed year partner's name, address, and TIN (or alternative form of identification as prescribed by forms, instruction, or other guidance) of each reviewed year partner of the partnership,

F) [t]he current or last address of each reviewed year partner that is known to the partnership, and

G) [a]ny other information prescribed by the IRS in forms, instructions, and other guidance.
(Reg. Section 301.6226-1(c)(3)(ii))

As with the partnership K-1 itself, consistent reporting rules apply to the statements provided to the partners under this election. Thus, Regulation Section 301.6226-1(e) provides:

> The election under this section, which includes filing and furnishing statements described in Section 301.6226-2, are actions of the partnership under Section 6223 and the regulations thereunder and, unless determined otherwise by the IRS, the partner's share of the adjustments, and the applicability of any penalties, additions to tax, and additional amounts as set forth in the statement are binding on the partner pursuant to Section 6223. Accordingly, a partner may not treat any partnership-related items (as defined in Section 301.6241–1(a)(6)(ii)) reflected on a statement described in Section 301.6226–2 on the partner's return inconsistently with how those items are

> treated on the statement that is filed with the IRS. (See Section 301.6222–1(c)(2) regarding partnership-related items, the treatment of which a partner is bound to under Section 6223.)

Making this election does not preclude the partnership from seeking judicial review of a partnership adjustment. (Reg. Section 301.6226-1(f))

Statements Furnished to the IRS & Partners for a Push-Out Election

Statements must be furnished both to partners who were partners in the reviewed year and the IRS for a partnership making the push-out election. These statements are to be provided in addition to, and separate from, any other statements required to be filed with the IRS and furnished to partners including Schedule K-1s (Form 1065). Also, a separate statement must be provided for each reviewed year (Reg. Section 301.6226-2(a)).

Time for Furnishing Statements

The statements are required to be furnished to review year partners no later than 60 days after the date all of the partnership adjustments for the statement are fully determined. The adjustments are considered fully determined on the later of:

- the expiration of the time to file a petition under Section 6234 with the Tax Court, applicable United States District Court or Court of Federal Claims, or

- if a petition under Section 6234 is filed, the date when the court's decision becomes final (Reg. Section 301.6626-2(b)(1)).

The partnership must take the following steps in determining the address of each reviewed year partner for sending the notices:

> The partnership must furnish the statement described in paragraph (a) of this section to each reviewed year partner in accordance with the forms, instructions, and other guidance prescribed by the IRS. If the partnership mails the statement, it must mail the statement to the current or last address of the reviewed year partner that is known to the partnership. If a statement is returned to the partnership as undeliverable, the partnership must undertake reasonable diligence to identify a correct address for the reviewed year partner to which the statement relates and, if a correct address is identified, mail the statement to the reviewed year partner at the correct address.

Since complying with all of the requirements of this regulation is required for a valid push out election, failure to exercise due diligence in determining the address could result in the partnership becoming liable for the entire imputed underpayment amount.

The IRS provides the following three examples related to the time for providing the statements:

EXAMPLE 1

During Partnership's 2020 taxable year, A, an individual, was a partner in Partnership and had an address at 123 Main Street. On February 1, 2021, A sells his interest in Partnership and informs Partnership that A moved to 456 Broad Street. On March 15, 2021, Partnership mails A's statement under Section 6031(b) for

the 2020 taxable year to 456 Broad Street. On June 1, 2023, A moves again but does not inform Partnership of A's new address. In 2023, the IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year and mails a notice of final partnership adjustment (FPA) to Partnership for that year that includes a single imputed underpayment. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226–1 with respect to the imputed underpayment and on May 31, 2024, timely mails a statement described in paragraph (a) of this section to A at 456 Broad Street. Although the statement was mailed to the last address for A that was known to Partnership, it is returned to Partnership as undeliverable because unknown to Partnership, A had moved. After undertaking reasonable diligence to obtain the correct address of A, Partnership is unable to ascertain the correct address. Therefore, pursuant to paragraph (b)(2) of this section, Partnership properly furnished the statement to A when it mailed the statement to 456 Broad Street.

EXAMPLE 2

The facts are the same as in Example 1 in paragraph (b)(3)(i) of this section, except that A lives at 789 Forest Avenue during all of 2024 and reasonable diligence would have revealed that 789 Forest Avenue is the correct address for A, but Partnership did not undertake such diligence. Because the statement was returned as undeliverable and Partnership did not undertake reasonable diligence to obtain the correct address for A, Partnership failed to properly furnish the statement with respect to A pursuant to paragraph (b)(2) of this section.

EXAMPLE 3

Partnership is a calendar year taxpayer. The IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year. On January 1, 2024, the IRS mails an FPA with respect to the 2020 taxable year to Partnership that includes a single imputed underpayment. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226–1 with respect to the imputed underpayment. Partnership timely files a petition for readjustment under Section 6234 with the Tax Court. The IRS prevails, and the Tax Court sustains all of the adjustments in the FPA with respect to the 2020 taxable year. The time to appeal the Tax Court decision expires, and the Tax Court decision becomes final on April 10, 2025. Under paragraph (b)(1)(ii) of this section, the adjustments in the FPA are finally determined on April 10, 2025, and Partnership must furnish the statements described in paragraph (a) of this section to its reviewed year partners and electronically file the statements with the IRS no later than June 9, 2025. See paragraph (c) of this section for the rules regarding filing the statements with the IRS.

Filing Statements with the IRS

Statements must be filed electronically with the IRS no later than 60 days after the date the partnership adjustments are finally determined for each reviewed year. Also, the partnership must transmit a summary of the statements filed and other information required in forms, instructions, and other IRS guidance (Reg. Section 301.6226-2(c)).

Correction of Statements

If the partnership or IRS discovers an error in statements it has issued, it files corrected statements with the IRS and the affected partner(s) in accordance with IRS forms, instructions, and other guidance (Reg. Section 301.6626-2(d)).

If the partnership discovers the error, different rules apply depending upon whether the error is found within 60 days of the due date or after that time.

If the error is found within 60 days of the due date for furnishing the statements, the partnership files the statements provided for previously with the IRS and the affected partner(s). The partnership does not need to seek the consent of the IRS in this situation (Reg. Section 301.6226-2(d)(2)(i)).

However, if the error is discovered more than 60 days after the statement due date, the partnership can only correct the error after seeking the consent of the IRS in accordance with forms, instructions, and guidance issued by the agency. Statements cannot be provided to the affected partners until IRS permission is received (Reg. Section 301.6226-2(d)(2)(ii)).

If the IRS discovers an error in the statements, the IRS may require the partnership to prepare corrected statements. If the partnership fails to correct an error when the IRS requires it, this can be treated by the IRS as a failure to provide the required statements under this regulation. Such a failure could invalidate the election and make the partnership again liable for the imputed understatement (Reg. Section 301.6226-2(d)(3)).

The correction must be taken into account by the partner in the reporting year—that is the year the original statement was provided to the partner even though that year is prior to the year in which the partner receives the correction (Reg. Section 301.6226-2(d)(4)).

Content of Statements

Each statement must include:

1. the name and correct TIN (or alternate form of identification as prescribed by forms, instructions, or other guidance) of the reviewed year partner to whom the statement is being furnished;

2. the current or last address of the reviewed year partner that is known to the partnership;

3. the reviewed year partner's share of items as originally reported for the reviewed year to the partner on statements furnished to the partner under Section 6031(b) and, if applicable, Section 6227;

4. the reviewed year partner's share of partnership adjustments determined under paragraph(f)(1) of this section;

5. modifications approved by the IRS with respect to the reviewed year partner or with respect to any indirect partner (as defined in Section 301.6241–1(a)(4)) that holds its interest in the partnership through its interest in the reviewed year partner);

6. the applicability of any penalty, addition to tax, or additional amount determined at the partnership level that relates to any adjustments allocable to the reviewed year partner and the adjustments to which the penalty, addition to tax, or additional amount relates, the section of the Internal Revenue Code (Code) under which each penalty, addition to tax, or additional amount is imposed, and the applicable rate of each penalty, addition to tax, or additional amount determined at the partnership level;

7. the date the statement is furnished to the reviewed year partner;

8. the partnership taxable year to which the adjustments relate; and

9. any other information required by forms, instructions, and other guidance prescribed by the IRS. (Reg. Sec. 301.6226-2(e)')

Calculation of Partner's Share of Adjustments

Except as provided in Reg. Section 301.6226-2(f)(1)(ii) or (iii) or (f)(2), in determining each partner's share of adjustments and other amounts, the adjusted items are reported to the reviewed year partner in the same manner as each adjusted partnership-related item was originally allocated to the reviewed year partner on the partnership return for the reviewed year (Reg. Section 301.6226-2(f)(1)(i)).

If the partnership-related item in question was not reported on the return in question, it is allocated to the partner in accordance with how the partnership-related item would have been allocated had it been allocated under rules that apply with respect to partnership allocations, including under the partnership agreement (Reg. Section 301.6226-2(f)(1)(ii)).

With regard to adjustments that reallocate items, the regulation provides that "[i]f an adjustment involves a partnership-related item to a specific partner or in a specific manner, including a reallocation of such an item, the reviewed year partner's share of the adjustment set forth in the statement is determined in accordance with the adjustment as finally determined (as described in (b)(1) of this section)." (Reg. Section 301.6226-2(f)(1)(iii))

"Any modifications approved by the IRS with respect to the reviewed year partner (or with respect to any indirect partner that holds its interest in the partnership through its interest in the reviewed year partner) under Section 301.6225–2 are disregarded for purposes of determining each partner's share of the adjustments under paragraph (f)(1) of this section." (Reg. Section 301.6226-2(f)(2))

Coordination with Certain Other Tax Provisions

Two special rules are added to deal with certain special cases by Regulation Section 301.6226- 2(g).

First, a provision is added to deal with partners who are registered investment companies (mutual funds) and real estate investment trusts (REITs). Regulation Section 301.6226-2(g)(1) provides the following:

> *Statements furnished to qualified investment entities described in Section 860.* If a reviewed year partner is a qualified investment entity within the meaning of Section 860(b) and the partner receives a statement described in paragraph (a) of this section, the partner may be able to avail itself of the deficiency dividend procedure described in Section 301.6226-3(b)(4).

The second provision deals with certain publicly traded partnerships, found at Regulation Section 301.6226-2(g)(2).

> *Liability for tax under Section 7704(g)(3).* An election under this section has no effect on a partnership's liability for any tax under Section 7704(g)(3) (regarding the exception for electing 1987 partnerships from the general rule that certain publicly traded partnerships are treated as corporations).

Finally, if the partnership makes an election to push out under Reg. Section 301.6226-1, the partnership must pay any tax required to be withheld under chapter 3 or chapter 4, if any, in accordance with Reg. Section 301.6241-6(b)(4).

Adjustments Taken into Account

Regulation Section 301.6226-3 has the methods to be used by the partners to compute the tax due when the partnership pushes out the adjustment. The regulations define the amount to be paid as the *additional reporting year tax*. The additional reporting year tax is either the total of all the individual year adjustment amounts (for the reviewed years and any other affected years) or, if an election is made, the safe harbor amount reported to the partner (Proposed Reg. Section 301.6226-3(a)).

The aggregate of the adjustment amounts is the total of the (1) correction amount for the first affected year and the (2) correction amounts for each of the intervening years (Reg. Section 301.6226-3(b)).

Correction Amount for the First Affected Year

The correction amount for the first affected year is defined at Reg. Section 301.6226- 3(b)(2). The first affected year is the reviewed year—that is, a year directly under exam at the partnership level. This is the amount that the partner's tax under Chapter 1 (income taxes) would increase for the first affected year after taking into account the partner's share of the partnership adjustments reported to that partner.

> The correction amount is the amount of chapter 1 tax that would have been imposed for the first affected year if the items as adjusted in the statement described in Section 301.6226–2 had been reported as such on the return for the first affected year less the sum of: (A) The amount of chapter 1 tax shown by the partner on the return for the first affected year (which includes amounts shown on an amended return for such year, including an amended return filed under Section 6225(c)(2) by the reviewed year partner); plus (B) Amounts not included in paragraph (b)(2)(ii)(A) of this section but previously assessed or collected (including the amounts defined in Section 1.6664–2(d) of this chapter and any amounts paid by the partner in accordance with Section 301.6225–2); less (C) The amount of rebates made (as defined in Section 1.6664–2(e) of this chapter). (Reg. Sec. 301.6226-3(b)(2)(ii))

The regulation also expresses this calculation as a formula:

Correction Amount for First Affected Year = A – (B + C – D)

where:

A = the amount of Chapter 1 tax that would have been imposed had the items as adjusted been properly reported on the return for the first affected year;

B = the amount shown as Chapter 1 tax on the return for the first affected year (taking into account amended returns);

C = amounts previously assessed or collected;

D = the amount of rebates made (Reg. Section 301.6226-3(b)(2)(iii)).

Correction Amounts for the Intervening Years

The partner also is required to take into account the change in tax that would have taken place for each intervening year. This calculation is defined at Reg. Section 301.6226-3(b) (3). The intervening years include years *before and after* the first affected year (which is also the partnership's reviewed year).

The partner must have recomputed his chapter 1 tax (income tax) for each year by taking into account any tax attributes that would be affected by the adjustments made to the first affected year (partnership's reviewed year). Regulation Section 301.6226-3(b)(3)(ii) provides the following full text definition:

> [T]he correction amount for each intervening year is the amount of chapter 1 tax that would have been imposed for the intervening year if any tax attribute of the partner for the intervening year had been adjusted after taking into account the reviewed year partner's share of the adjustments for the first affected year as described in paragraph (b)(2) of this section (and if any tax attribute of the partner for the intervening year had been adjusted, after taking into account any adjustments to tax attributes of the partner in any prior intervening year(s)) exceeds less the sum of—(A) The amount of chapter 1 tax shown by the partner on the return for the intervening year (which includes amounts shown on an amended return for such year, including an amended return filed under Section 6225(c)(2) by a reviewed year partner); plus (B) Amounts not included in paragraph (b)(3)(ii)(A) of this section but previously or collected (including the amounts defined in Section 1.6664–2(d) of this chapter and any amounts paid by the partner in accordance with Section 301.6225–2); less (C) The amount of rebates made (as defined in Section 1.6664–2(e) of this chapter). (Reg. Section 301.6226-3(b)(3))

As with the correction amount for the first affected year, the regulations provide a formula for the correction amount for each intervening year.

Correction Amount for Intervening Year = A – (B + C – D)

where:

A = the amount of chapter 1 tax that would have been imposed for the intervening year;

B = the amount shown as chapter 1 tax on the return for the intervening year (taking into account amended returns);

C = amounts not shown previously assessed or collected; and

D = the amount of rebates made (Reg. Section 301.6226-3(b)(3)(iii)).

Qualified Investment Entity

Special rules that apply for a partner that is a "qualified investment entity" (mutual fund or REIT) are described in Reg. Section 301.6226-3(b)(4).

If a qualified investment entity (QIE) within the meaning of Section 860(b) receives a statement described in Section 301.6226-2(a) and correctly makes a determination within the meaning of Section 860(e)(4) that one or more of the adjustments reflected in the statement is an adjustment within the meaning of Section 860(d) with respect to that QIE for a taxable year, the QIE may

distribute deficiency dividends within the meaning of Section 860(f) for that taxable year and avail itself of the deficiency dividend procedures set forth in Section 860. If the QIE utilizes the deficiency dividend procedures with respect to adjustments in a statement described in Section 301.6226-2(a), the QIE may claim a deduction for deficiency dividends against the adjustments furnished to the QIE in the statement in calculating any correction amounts under paragraphs (b)(2) and (b)(3) of this section, and interest on that correction amount under paragraph (d) of this section, to the extent that the QIE makes deficiency dividend distributions under Section 860(f) and complies with all requirements of Section 860 and the regulations thereunder. A deficiency dividends deduction under this paragraph (b)(4) and Section 860(a) has no effect on a QIE's liability for any penalties reflected in a statement described in Section 301.6226-2(a).

Interest on the Correction Amounts

The taxpayer computes the amount of interest that must be paid with the return for the reporting year by computing interest using the underpayment rate as computed under IRC Section 6621(a)(2) plus 2% (that is, substituting 5% for 3% in IRC Section 6621(a)(2)) (Reg. Section 301.6226-3(c)(3)).

Interest on penalties is calculated using the underpayment rate plus 2% from the due date (without extensions) of the reviewed year's partner's return for the first affected year until the amount is paid.

Penalties

Even though a push out election is made under Section 6226, the applicability of any penalty, addition to tax, and additional amount that relates to a partnership item is determined at the partnership level in accordance with IRC Section 6221(a). However, the reviewed year partners are liable for these penalties.

The actual penalty is calculated at the individual partner level. Reg. Section 301.6226-3(d)(2) provides:

> A reviewed year partner calculates the amount of any penalty, addition to tax, or additional amount relating to the partnership adjustments taken into account under paragraph (b)(1) of this section as if the correction amount were an underpayment or understatement of the reviewed year partner for the first affected year or intervening year, as applicable. The calculation of any penalty, addition to tax, or additional amount is based on the characteristics of, and facts and circumstances applicable to, the reviewed year partner for the first affected year or intervening year, as applicable after taking into account the partnership adjustments reflected on the statement. If after taking into account the partnership adjustments in accordance with this section, the reviewed year partner does not have an underpayment, or has an understatement that falls below the applicable threshold for the imposition of a penalty, no penalty is due from that reviewed year partner under this paragraph (d)(2). For penalties in the case of a pass-through partner that makes a payment under paragraph (e)(4) of this section, see paragraph (e)(4)(iv) of this section.

If a partner wishes to dispute a penalty, the IRS requires a "pay first then appeal" approach. As Reg. Section 301.6226-3(d)(3) provides:

> A reviewed year partner (including a pass-through partner (as defined in Section 301.6241-1(a)(5)) claiming that a penalty, addition to tax, or additional amount that relates to a partnership adjustment reflected on a statement described in Section 301.6226-2 (or paragraph (e)(3) of this section) is not due because of a partner-level defense must first pay the penalty and file a claim for refund for the

> reporting year. Partner-level defenses are limited to those that are personal to the reviewed year partner (for example, a reasonable cause and good faith defense under Section 6664(c) that is based on the facts and circumstances applicable to the partner).

Pass-Through Partners & Foreign Entities

If a partnership makes a push out election, any pass-through entity that is a partner in the partnership will need to issue statements to its partners and a report to the IRS of the adjustments.

Issuance of Statements

The regulation provides the following treatment for a pass-through partner when the partnership under exam makes a push out adjustment and furnishes a statement to the pass-through partner:

> Except as provided in paragraph (e)(6) of this section, if a pass-through partner is furnished a statement described in Section 301.6226-2 (including a statement described in paragraph (e)(3) of this section) with respect to adjustments of a partnership that made an election under Section 301.6226-1 (audited partnership), the pass-through partner must file with the IRS a partnership adjustment tracking report in accordance with forms, instructions, or other guidance prescribed by the IRS on or before the due date described in paragraph (e)(3)(ii) of this section, and file and furnish statements in accordance with paragraph (e)(3) of this section. The pass-through partner must comply with paragraph (e) of this section with respect to each statement furnished to the pass-through partner.[165]

The regulation provides the following consequences if a pass-through partner fails to provide the statements or file the tracking report with the IRS.

For a failure to provide the statements, the regulations provide for the following:

> If any pass-through partner fails to timely file and furnish correct statements in accordance with paragraph (e)(3) of this section, the pass-through partner must compute and pay an imputed underpayment, as well as any penalties, additions to tax, additional amounts, and interest with respect to the adjustments reflected on the statement furnished to the pass-through partner in accordance with paragraph (e)(4) of this section. The IRS may assess such imputed underpayment against such pass-through partner without regard to the limitations under Section 6232(b). See Section 301.6232-1(c)(2). A failure to furnish statements in accordance with paragraph (e)(3) of this section is treated as a failure to timely pay an imputed underpayment required under paragraph (e)(4)(i) of this section, unless the pass-through partner computes and pays an imputed underpayment in accordance with paragraph (e)(4) of this section. See Section 6651(i).[166]

[165] Reg. Section 301.6226-3(e)(1)

[166] Reg. Section 301.6226-3(e)(2)(i)

For a failure to provide the tracking statement to the IRS, the following consequences apply:

> Failure to timely file the partnership adjustment tracking report as required in paragraph (e)(1) of this section, or filing such report without showing the information required under paragraph (e)(1) of this section, is subject to the penalty imposed by Section 6698.[167]

The pass-through partner's statements to any partners (or equity holders) that held an interest at any time during the reviewed year, as well as filing a copy with the IRS.[168]

The statements must be furnished to the partners no later than the extended due date for the return of the audited partnership for the adjustment year. That date remains fixed even if the audited partnership does not file a return for the adjustment year or does not request an extension of time to file a return for the year.[169]

The statement contains the following contents:

(A) The name and taxpayer identification number (TIN) of the audited partnership;

(B) The adjustment year of the audited partnership;

(C) The extended due date for the return for the adjustment year of the audited partnership (as described in paragraph (e)(3)(ii) of this section);

(D) The date on which the audited partnership furnished its statements required under Section 301.6226-2(b);

(E) The name and TIN of the partnership that furnished the statement to the pass-through partner if different from the audited partnership;

(F) The name and TIN of the pass-through partner;

(G) The pass-through partner's taxable year to which the adjustments reflected on the statements described in paragraph (e)(3) of this section relates;

(H) The name and TIN (or alternative form of identification as prescribed by forms, instructions, or other guidance) of the affected partner to whom the statement is being furnished;

(I) The current or last address of the affected partner that is known to the pass-through partner;

(J) The affected partner's share of items as originally reported to such partner under Section 6031(b) and, if applicable, Section 6227, for the taxable year to which the adjustments reflected on the statement furnished to the pass-through partner relate;

(K) The affected partner's share of partnership adjustments determined under Section 301.6226-2(f)(1) as if the affected partner were the reviewed year partner and the pass-through partner were the partnership;

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[167] Reg. Section 301.6226-3(e)(2)(ii)

[168] Reg. Section 301.6226-3(e)(3)(i)

[169] Reg. Section 301.6226-3(e)(3)(ii)

(L) Modifications approved by the IRS with respect to the affected partner that holds its interest in the audited partnership through the pass-through partner;

(M) The applicability of any penalties, additions to tax, or additional amounts determined at the audited partnership level that relate to any adjustments allocable to the affected partner and the adjustments allocated to the affected partner to which such penalties, additions to tax, or additional amounts relate, the section of the Internal Revenue Code under which each penalty, addition to tax, or additional amount is imposed, and the applicable rate of each penalty, addition to tax, or additional amount; and

(N) Any other information required by forms, instructions, and other guidance prescribed by the IRS.[170]

The partner receiving this statement must treat it in the same fashion as a push out statement received directly from the partnership under examination.[171]

> An affected partner that is a pass-through partner must take into account the adjustments reflected on such a statement in accordance with this paragraph (e). An affected partner that is not a pass-through partner must take into account the adjustments reflected on such a statement in accordance with this section by treating references to "reviewed year partner" as "affected partner." For purposes of this paragraph (e)(3)(iv), an affected partner that is not a pass-through partner takes into account the adjustments in accordance with this section by determining its reporting year based on the date upon which the audited partnership furnished its statements to its reviewed year partners (as described in paragraph (a) of this section). No addition to tax under Section 6651 related to any additional reporting year tax will be imposed if an affected partner that is not a pass-through partner reports and pays the additional reporting year tax within 30 days of the extended due date for the return for the adjustment year of the audited partnership (as described in paragraph (e)(3)(ii) of this section).

The pass-through partner that issues statements to its affected partners is responsible for any withholding under chapter 3 or chapter 4 that may be due on the adjustment.[172]

Pass-Through Partner Fails to Issue Statements

If a pass-through partner fails to issue the statements to affected partners described earlier, the regulations provide:

> . . . [T]he pass-through partner must compute and pay an imputed underpayment determined under paragraph (e)(4)(iii) of this section. The pass-through partner must also pay any penalties, additions to tax, additional amounts, and interest as determined under paragraph (e)(4)(iv) of this section. A failure to timely pay an imputed underpayment required under this paragraph (e)(4) is subject to penalty under Section 6651(i).[173]

[170] Reg. Section 301.6226-3(e)(iii)

[171] Reg. Section 301.6226-3(e)(iv)

[172] Reg. Section 301.6226-3(e)(v)

[173] Reg. Section 301.6226-3(e)(4)(i)

The tax, penalties, and interest must be paid no later than the extended due date for return of the adjustment year of the audited partnership. The payment must be made in accordance with forms, instructions, and other guidance.[174]

The computation of the imputed adjustment proceeds as follows:

> The imputed underpayment under paragraph (e)(4)(i) of this section is computed in the same manner as an imputed underpayment under Section 6225 and Section 301.6225-1, except that adjustments reflected on the statement furnished to the pass-through partner under Section 301.6226-2 are treated as partnership adjustments (as defined in Section 301.6241-1(a)(6)) for the first affected year. Any modification approved by the IRS under Section 301.6225-2 with respect to the pass-through partner (including any modifications with respect to a relevant partner (as defined in Section 301.6225-2(a)) that holds its interest in the audited partnership through its interest in the pass-through partner) reflected on the statement furnished to the pass-through partner under Section 301.6226-2 (or paragraph (e)(3) of this section) is taken into account in calculating the imputed underpayment under this paragraph (e)(4)(iii). Any modification that was not approved by the IRS under Section 301.6225-2 may not be taken into account in calculating the imputed underpayment under this paragraph (e)(4)(iii).[175]

The computation of penalties is detailed in the regulations in this case:

> A pass-through partner must compute and pay any applicable penalties, additions to tax, and additional amounts on the imputed underpayment calculated under paragraph (e)(4)(iii) of this section as if such amount were an imputed underpayment for the pass-through partner's first affected year. See Section 301.6233(a)-1(c).[176]

Similarly, the regulations provide for the computation of interest:

> A pass-through partner must pay interest on the imputed underpayment calculated under paragraph (e)(4)(iii) of this section in accordance with paragraph (c) of this section as if such imputed underpayment were a correction amount for the first affected year.[177]

[174] Reg. Section 301.6226-3(e)(4)(ii)

[175] Reg. Section 301.6226-3(e)(4)(iii)

[176] Reg. Section 301.6226-3(e)(4)(iv)(A)

[177] Reg. Section 301.6226-3(e)(4)(iv)(B)

For adjustments that do not result in an imputed underpayment, the regulations provide the following treatment:

> Adjustments taken into account under paragraph (e)(4) of this section that do not result in an imputed underpayment (as defined in Section 301.6225-1(f)) are taken into account by the pass-through partner in accordance with Section 301.6225-3 in the taxable year of the pass-through partner that includes the date the imputed underpayment required under paragraph (e)(4)(i) of this section is paid. If, after making the computation described in paragraph (e)(4)(iii) of this section, no imputed underpayment exists and therefore no payment is required under paragraph (e)(4)(i) of this section, the adjustments that did not result in an imputed underpayment are taken into account by the pass-through partner in accordance with Section 301.6225-3 in the taxable year of the pass-through partner that includes the date the statement described in Section 301.6226-2 (or paragraph (e)(3) of this section) is furnished to the pass-through partner.[178]

The regulations also provide the following rules for coordination with chapters 3 and 4 in this case:

> If a pass-through partner pays an imputed underpayment described in paragraph (e)(4)(i) of this section, Section 301.6241-6(b)(3) applies to the pass-through partner by substituting "pass-through partner" for "partnership" where Section 301.6241-6(b)(3) refers to the partnership that pays the imputed underpayment.[179]

Treatment of S Corporation Partners

If the pass-through partner is an S corporation, the S corporation shall be treated as if it were a partnership and its shareholders were partners.[180]

Treatment of Trust & Estate Partners

If the pass-through partner is a trust or estate, a trust and its beneficiaries or an estate and its beneficiaries are treated as a partner and a partnership.[181]

Pass-Through Partner Subject to Chapter 1 Tax

S corporations, trusts, and estates may be subject to a chapter 1 tax on some or all of the adjustment. For instance, if a trust makes no distributions and, thus, has no income distribution deduction, the trust pays tax on the income. In such a case, the regulations provide a special rule to take this payment of tax into account:

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[178] Reg. Section 301.6226-3(e)(4)(v)

[179] Reg. Section 301.6226-3(e)(4)(vi)

[180] Reg. Section 301.6226-3(e)(5)(i)

[181] Reg. Section 301.6226-3(e)(5)(ii)

> A pass-through partner that is subject to tax under chapter 1 of the Code on the adjustments (or a portion of the adjustments) reflected on the statement furnished to such partner under Section 301.6226-2 (or paragraph (e)(3) of this section) takes the adjustments into account under this paragraph (e)(6) when the pass-through partner calculates and pays the additional reporting year tax as determined under paragraph (b) of this section and furnishes statements to its partners in accordance with paragraph (e)(3) of this section. Notwithstanding the prior sentence, a pass-through partner is only required to include on a statement under paragraph (e)(3) of this section the adjustments that would be required to be included on statements furnished to owners or beneficiaries under Sections 6037 and 6034A, as applicable, if the pass-through partner had correctly reported the items for the year to which the adjustments relate. If the pass-through partner fails to comply with the requirements of this paragraph (e)(6), the pass-through partner must compute and pay an imputed underpayment, as well as any penalties, additions to tax, additional amounts, and interest with respect to the adjustments reflected on the statement furnished to such partner in accordance with paragraph (e)(4) of this section.[182]

Partners Subject to Withholding Under Chapter 3 or Chapter 4

The regulations provide the following rules for any partner that is subject to withholding under Chapter 3 or Chapter 4.

> A reviewed year partner that is subject to withholding under Section 301.6241-6(b)(4) must file an income tax return for the reporting year to report its additional reporting year tax and its share of any penalties, additions to tax, additional amounts, and interest (notwithstanding any filing exception in Section 1.6012-1(b)(2)(i) or Section 1.6012-2(g)(2)(i) of this chapter). The amount of tax paid by a partnership under Section 301.6241-6(b)(4) is allowed as a credit under Section 33 to the reviewed year partner to the extent that the tax is allocable to the reviewed year partner (within the meaning of Section 1.1446-3(d)(2) of this chapter) or is actually withheld from the reviewed year partner (within the meaning of Section 1.1464-1(a) or Section 1.1474-3 of this chapter). The credit is allowed against the reviewed year partner's income tax liability for its reporting year. The reviewed year partner must substantiate the credit by attaching the applicable Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," or Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax," to its income tax return for the reporting year, as well as satisfying any other requirements prescribed by the IRS in forms and instructions.[183]

Wholly Owned Grantor Trusts & Disregarded Entities

The regulations provide a not-terribly-surprising treatment for wholly-owned grantor trusts and disregarded entity partners:

> In the case of a reviewed year partner that is a wholly-owned entity disregarded as separate from its owner for federal income tax purposes in the reviewed year or a trust that is wholly owned by only one person in the reviewed year, whether the grantor or another person, and where the trust reports the owner's information to

[182] Reg. Section 301.6226-3(e)(6)

[183] Reg. Section 301.6226-3(f)

payors under Section 1.671-4(b)(2)(i)(A) of this chapter and that is furnished a statement described in Section 301.6226-2 (or paragraph (e)(3) of this section), the owner of the disregarded entity or wholly-owned grantor trust must take into account the adjustments reflected on that statement in accordance with this section as if the owner were the reviewed year partner.[184]

Examples

The IRS has provided nine examples applying the provisions of the regulation. We produce below the first three of the IRS examples. For purposes of the examples, each partner is a calendar year partner (unless otherwise stated), no modifications are requested by the partnership under Reg. Section 301.6225-2 (unless otherwise stated), and the highest rate of tax for individuals is assumed to be 40%. For corporations, the highest rate is assumed to be 20%. The long-term capital gains rate is assumed to be 15%.

EXAMPLE 1

On its partnership return for the 2020 tax year, Partnership reported ordinary income of $1,000 and charitable contributions of $400. On June 1, 2023, the IRS mails a notice of final partnership adjustment (FPA) to Partnership for Partnership's 2020 year disallowing the charitable contribution in its entirety and determining that a 20% accuracy-related penalty under Section 6662(b) applies to the disallowance of the charitable contribution, and setting forth a single imputed underpayment with respect to such adjustments. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226–1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and files a timely petition in the Tax Court challenging the partnership adjustments. The Tax Court determines that Partnership is not entitled to any of the claimed $400 in charitable contributions and upholds the applicability of the penalty. The decision regarding Partnership's 2020 tax year becomes final on December 15, 2025. Pursuant to Section 301.6226–2(b), the partnership adjustments are finally determined on December 15, 2025. On February 2, 2026, Partnership files the statements described under Section 301.6226–2 with the IRS and furnishes to partner A, an individual who was a partner in Partnership during 2020, a statement described in Section 301.6226–2. A had a 25% interest in Partnership during all of 2020 and was allocated 25% of all items from Partnership for that year. The statement shows A's share of ordinary income reported on Partnership's return for the reviewed year of $250 and A's share of the charitable contribution reported on Partnership's return for the reviewed year of $100. The statement also shows an adjustment to A's share of the charitable contribution, a reduction of $100 resulting in $0 charitable contribution allocated to A from Partnership for 2020. In addition, the statement reports that a 20% accuracy-related penalty under Section 6662(b) applies. A must pay the additional reporting year tax as determined in accordance with paragraph (b) of this section, in addition to A's penalties and interest. A computes his additional reporting year tax as follows. First, A determines the correction amount for the first affected year (the 2020 taxable year) by taking into account A's share of the partnership adjustment (-$100 reduction in charitable contribution) for the 2020 taxable year. A determines the amount by which his chapter 1 tax for 2020 would have increased or decreased if the $100 adjustment to the charitable contribution from Partnership were taken into account for that year. There is no adjustment to tax attributes in A's intervening years as a result of the adjustment to the charitable contribution for 2020. Therefore, A's aggregate of the correction amounts is the correction amount for 2020, A's first affected year. In addition to the aggregate of the correction amounts being added to the chapter 1 tax that A owes for 2026, the reporting year, A must calculate a 20% accuracy-related penalty on A's underpayment attributable to the $100 adjustment to the charitable contribution, as well as interest on the correction amount for the first affected year and the penalty determined in accordance with paragraph (c) of this

[184] Reg. Section 301.6226-3(g)

section. Interest on the correction amount for the first affected tax year runs from April 15, 2021, the due date of A's 2020 return (the first affected tax year) until A pays this amount. In addition, interest runs on the penalty from April 15, 2021, the due date of A's 2020 return for the first affected year until A pays this amount. On his 2026 income tax return, A must report the additional reporting year tax determined in accordance with paragraph (b) of this section, which is the correction amount for 2020, plus the accuracy-related penalty determined in accordance with paragraph (d) of this section, and interest determined in accordance with paragraph (c) of this section on the correction amount for 2020 and the penalty.

EXAMPLE 2

On its partnership return for the 2020 tax year, Partnership reported an ordinary loss of $500. On June 1, 2023, the IRS mails an FPA to Partnership for the 2020 taxable year determining that $300 of the $500 in ordinary loss should be recharacterized as a long-term capital loss. Partnership has no long-term capital gain for its 2020 tax year. The FPA for Partnership's 2020 tax year reflects an adjustment of an increase in ordinary income of $300 (as a result of the disallowance of the recharacterization of $300 from ordinary loss to long-term capital loss) and an imputed underpayment related to that adjustment, as well as an adjustment of an additional $300 in long-term capital loss for 2020 which does not result in an imputed underpayment under Section 301.6225–1(f). Partnership makes a timely election under Section 6226 in accordance with Section 301.6226–1 with respect to the imputed underpayment in the FPA and does not file a petition for readjustment under Section 6234. Accordingly, under Section 301.6226–1(b)(2) and Section 301.6225–3(b)(6), the adjustment year partners (as defined in Section 301.6241–1(a)(2)) do not take into account the $300 long-term capital loss that does not result in an imputed underpayment. Rather, the $300 long-term capital loss is taken into account by the reviewed year partners. The time to file a petition expires on August 30, 2023. Pursuant to Section 301.6226–2(b), the partnership adjustments become finally determined on August 31, 2023. On September 30, 2023, Partnership files with the IRS statements described in Section 301.6226–2 and furnishes statements to all of its reviewed year partners in accordance with Section 301.6226–2. One partner of Partnership in 2020, B (an individual), had a 25% interest in Partnership during all of 2020 and was allocated 25% of all items from Partnership for that year. The statement filed with the IRS and furnished to B shows B's allocable share of the ordinary loss reported on Partnership's return for the 2020 taxable year as $125. The statement also shows an adjustment to B's allocable share of the ordinary loss in the amount of -$75, resulting in a corrected ordinary loss allocated to B of $50 for taxable year 2020 ($125 originally allocated to B less $75 which is B's share of the adjustment to the ordinary loss). In addition, the statement shows an increase to B's share of long-term capital loss in the amount of $75 (B's share of the adjustment that did not result in the imputed underpayment with respect to Partnership). B must pay the additional reporting year tax as determined in accordance with paragraph (b) of this section. B computes his additional reporting year tax as follows. First, B determines the correction amount for the first affected year (the 2020 taxable year) by taking into account B's share of the partnership adjustments (a $75 reduction in ordinary loss and an increase of $75 in long-term capital loss) for the 2020 taxable year. B determines the amount by which his chapter 1 tax for 2020 would have increased or decreased if the $75 adjustment to ordinary loss and the $75 adjustment to long-term capital loss from Partnership were taken into account for that year. Second, B determines if there is any increase or decrease in chapter 1 tax for any intervening year as a result of the adjustment to the ordinary and capital losses for 2020. B's aggregate of the correction amounts is the correction amount for 2020, B's first affected year plus any correction amounts for any intervening years. B is also liable for any interest on the correction amount for the first affected year and for any intervening year as determined in accordance with paragraph (c) of this section.

EXAMPLE 3

On its partnership return for the 2020 tax year, Partnership, a domestic partnership, reported U.S. source dividend income of $2,000. On June 1, 2023, the IRS mails an FPA to Partnership for Partnership's 2020 year increasing the amount of U.S. source dividend income to $4,000 and determining that a 20% accuracy-related penalty under Section 6662(b) applies to the increase in U.S. source dividend income. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226–1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and does not file a petition for readjustment under Section 6234. The time to file a petition expires on August 30, 2023. Pursuant to Section 301.6226–2(b), the partnership adjustments become finally determined on August 31, 2023. On September 30, 2023, Partnership files the statements described under Section 301.6226–2 with the IRS and furnishes to partner C, a nonresident alien individual who was a partner in Partnership during 2020 (and remains a partner in Partnership in 2023), a statement described in Section 301.6226–2. C had a 50% interest in Partnership during all of 2020 and was allocated 50% of all items from Partnership for that year. The statement shows C's share of U.S. source dividend income reported on Partnership's return for the reviewed year of $1,000 and an adjustment to U.S. source dividend income of $1,000. In addition, the statement reports that a 20% accuracy-related penalty under Section 6662(b) applies. Under Section 301.6241–6(b)(4)(i), because the additional $1,000 in U.S. source dividend income allocated to C is an amount subject to withholding (as defined in Section 301.6241–6(b)(2)), Partnership must pay the amount of tax required to be withheld on the adjustment. See Sections 1.1441–1(b)(1) and 1.1441–5(b)(2)(i)(A) of this chapter. Under Section 301.6241–6(b)(4)(ii), Partnership may reduce the amount of withholding tax it must pay because it has valid documentation from 2020 that establishes that C was entitled to a reduced rate of withholding in 2020 on U.S. source dividend income of 10 percent pursuant to a treaty. Partnership withholds $100 of tax from C's distributive share, remits the tax to the IRS, and files the necessary return and information returns required by Section 1.1461–1 of this chapter. On his 2023 return, C must report the additional reporting year tax determined in accordance with paragraph (b) of this section, the accuracy-related penalty determined in accordance with paragraph (d) of this section, and interest determined in accordance with paragraph (c) of this section on the correction amount for the first affected year, the correction amount for any intervening year, and the penalty. Under paragraph (f) of this section, C may claim the $100 withholding tax paid by Partnership pursuant to Section 301.6241–6(b)(4)(i) as a credit under Section 33 against C's income tax liability on his 2023 return.

EXAMPLE 4

On its partnership return for the 2020 tax year, Partnership reported ordinary income of $100 and a long-term capital gain of $40. Partnership had four equal partners during the 2020 tax year: E, F, G, and H, all of whom were individuals. On its partnership return for the 2020 tax year, the entire long-term capital gain was allocated to partner E and the ordinary income was allocated to all partners based on their equal (25%) interest in Partnership. The IRS initiates an administrative proceeding with respect to Partnership's 2020 taxable year and determines that the long-term capital gain should have been allocated equally to all four partners and that Partnership should have recognized an additional $10 in ordinary income. On June 1, 2023, the IRS mails an FPA to Partnership reflecting the reallocation of the $40 long-term capital gain so that F, G, and H each have a $10 increase in long-term capital gain and E has a $30 reduction in long-term capital gain for 2020. In addition, the FPA reflects the partnership adjustment increasing ordinary income by $10. The FPA reflects a general imputed underpayment with respect to the increase in ordinary income and a specific imputed underpayment with respect to the increase in long-term capital gain allocated to F, G, and H. In addition, the FPA reflects a $30 partnership adjustment that does not result in an imputed underpayment, that is, the reduction of $30 in long-term capital gain with respect to E that is associated with the specific imputed underpayment in accordance with Section 301.6225-1(g)(2)(iii)(B). Partnership

makes a timely election under Section 6226 in accordance with Section 301.6226-1 with respect to the specific imputed underpayment relating to the reallocation of long-term capital gain. Partnership does not file a petition for readjustment under Section 6234. The time to file a petition expires on August 30, 2023. Pursuant to Section 301.6226-2(b), the partnership adjustments become finally determined on August 31, 2023. Partnership timely pays the general imputed underpayment that resulted from the partnership adjustment to ordinary income. On September 30, 2023, Partnership files with the IRS statements described in Section 301.6226-2 and furnishes statements to its partners reflecting their share of the partnership adjustments as finally determined in the FPA that relate to the specific imputed underpayment, that is, the reallocation of long-term capital gain. The statements for F, G, and H each reflect a partnership adjustment of an additional $10 of long-term capital gain for 2020. The statement for E reflects a partnership adjustment of a reduction of $30 of long-term capital gain for 2020. Because E, F, G, and H are all individuals, all partners must report the additional reporting year tax as determined in accordance with paragraph (b) of this section in the partners' reporting year, which is 2023. They compute their additional reporting year tax as follows. First, they determine the correction amount for the first affected year (the 2020 taxable year) by taking into account their share of the partnership adjustments for the 2020 taxable year. They each determine the amount by which their chapter 1 tax for 2020 would have increased or decreased if the adjustment to long-term capital gain from Partnership were taken into account for that year. Second, they determine if there is any increase or decrease in chapter 1 tax for any intervening year as a result of the adjustment to the long-term capital gain for 2020. Their aggregate of the correction amounts is the sum of the correction amount for 2020, their first affected year and any correction amounts for any intervening years. They are also liable for any interest on the correction amount for the first affected year and for any intervening year as determined in accordance with paragraph (c) of this section.

EXAMPLE 5

On its partnership return for the 2020 taxable year, Partnership reported a long-term capital loss of $500. During an administrative proceeding with respect to Partnership's 2020 taxable year, the IRS mails a notice of proposed partnership adjustment (NOPPA) in which it proposes to disallow $200 of the reported $500 long-term capital loss, the only adjustment. Accordingly, the imputed underpayment reflected in the NOPPA is $80 ($200 x 40%). F, a C corporation partner with a 50% interest in Partnership, received 50% of all long-term capital losses for 2020. As part of the modification process described in Section 301.6225-2(d)(2), F files an amended return for 2020 taking into account F's share of the partnership adjustment ($100 reduction in long-term capital loss) and pays the tax owed for 2020, including interest. Also, as part of the modification process, F also files amended returns for 2021 and 2022 and pays additional tax (and interest) for these years because the reduction in long-term capital loss for 2020 affected the tax due from F for 2021 and 2022. See Section 301.6225-2(d)(2). The reduction of the long-term capital loss in 2020 did not affect any other taxable year of F. This is the only modification requested. The IRS approves the modification with respect to F and on June 1, 2023, mails an FPA to Partnership for Partnership's 2020 year reflecting the partnership adjustment reducing the long-term capital loss in the amount of $200. The FPA also reflects the modification to the imputed underpayment based on the amended returns filed by F taking into account F's share of the reduction in the long-term capital loss. Therefore, the imputed underpayment in the FPA is $40 ($100 x 40%). Partnership makes a timely election under Section 6226 in accordance with Section 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and files a timely petition in the Tax Court challenging the partnership adjustments. The Tax Court upholds the determinations in the FPA and the decision regarding Partnership's 2020 tax year becomes final on December 15, 2025. Pursuant to Section 301.6226-2(b), the partnership adjustments are finally determined on December 15, 2025. On February 1, 2026, Partnership files the statements described under Section 301.6226-2 with the IRS and furnishes to its partners statements reflecting their shares of the partnership adjustment. The statement issued to F reflects F's share of the partnership adjustment for Partnership's 2020 taxable year as finally determined by the Tax Court. The statement shows F's share of the long-term capital loss adjustment for the reviewed year of $100, as well as the $100 long-term capital

loss taken into account by F as part of the amended return modification. Accordingly, in accordance with paragraph (b) of this section, when F computes its correction amounts for the first affected year (the 2020 taxable year) and the intervening years (the 2021 through 2026 taxable years), F computes any increase or decrease in chapter 1 tax for those years using the returns for the 2020, 2021, and 2022 taxable years as amended during the modification process and taking into account any chapter 1 tax paid with those amended returns. F also takes into account the interest paid with F's amended returns when determining the interest under paragraph (c) of this section that must be paid in the reporting year.

EXAMPLE 6

Partnership has two equal partners for the 2020 tax year: M (an individual) and J (a partnership). For the 2020 tax year, J has two equal partners—K and L—both individuals. On June 1, 2023, the IRS mails an FPA to Partnership for Partnership's 2020 year increasing Partnership's ordinary income by $500,000 and asserting an imputed underpayment of $200,000. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and does not file a petition for readjustment under Section 6234. The time to file a petition expires on August 30, 2023. Pursuant to Section 301.6226-2(b), the partnership adjustments become finally determined on August 31, 2023. Therefore, Partnership's adjustment year is 2023, the due date of the adjustment year return is March 15, 2024, and the extended due date for the adjustment year return is September 16, 2024. On October 12, 2023, Partnership timely files with the IRS statements described in Section 301.6226-2 and timely furnishes statements to its partners reflecting their share of the partnership adjustments as finally determined in the FPA. The statements to M and J each reflect a partnership adjustment of $250,000 of ordinary income. M takes her share of the adjustments reflected on the statements furnished by Partnership into account on M's return for the 2023 tax year in accordance with paragraph (b) of this section. On April 1, 2024, J files the adjustment tracking report and files and furnishes statements to K and L reflecting each partner's share of the adjustments reflected on the statements Partnership furnished to J. K and L must take their share of adjustments reflected on the statements furnished by J into account on their returns for the 2023 tax year in accordance with paragraph (b) of this section by treating themselves as reviewed year partners for purposes of that paragraph.

EXAMPLE 7

On its partnership return for the 2020 tax year, Partnership reported that it placed Asset, which had a depreciable basis of $210,000, into service in 2020 and depreciated Asset over five years, using the straight-line method. Accordingly, Partnership claimed depreciation of $42,000 in each year related to Asset. Partnership has two equal partners for the 2020 tax year: M (a partnership) and N (an S corporation). For the 2020 tax year, N has one shareholder, O, who is an individual. On June 1, 2023, the IRS mails an FPA to Partnership for Partnership's 2020 year. In the FPA, the IRS determines that Asset should have been depreciated over 7 years instead of 5 years and adjusts the depreciation for the 2020 tax year to $30,000 instead of $42,000 resulting in a $12,000 adjustment. This adjustment results in an imputed underpayment of $4,800 ($12,000 x 40%). Partnership makes a timely election under Section 6226 in accordance with Section 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and does not file a petition for readjustment under Section 6234. The time to file a petition expires on August 30, 2023. Pursuant to Section 301.6226-2(b), the partnership adjustments become finally determined on August 31, 2023. On October 12, 2023, Partnership timely files with the IRS statements described in Section 301.6226-2 and furnishes statements to its partners reflecting their share of the partnership adjustments as finally determined in the FPA. The statements to M and N reflect a partnership adjustment of $6,000 of ordinary income for the 2020 tax year. On February 1, 2024, N takes the adjustments into account under paragraph (e)(3) of this section by filing a partnership adjustment tracking report and furnishing a statement to O reflecting her share of the adjustments reported to N on the statement it

received from Partnership. M does not furnish statements and instead chooses to calculate and pay an imputed underpayment under paragraph (e)(4) of this section equal to $1,200 ($6,000 x 40%) on the adjustments reflected on the statement it received from Partnership plus interest on the amount calculated in accordance with paragraph (e)(4)(iv)(B) of this section. On her 2023 return, O properly takes the adjustments into account under this section. Therefore, O reports and pays the additional reporting year tax determined in accordance with paragraph (b) of this section, which is the correction amount for 2020 plus any correction amounts for 2021 and 2022 (if the adjustments in 2020 resulted in any changes to the tax attributes of O in those years), and pays interest determined in accordance with paragraph (c) of this section on the correction amounts for each of those years.

EXAMPLE 8

On its partnership return for the 2020 tax year, Partnership reported $1,000 of ordinary loss. Partnership has two equal partners for the 2020 tax year: P and Q, both S corporations. For the 2020 tax year, P had one shareholder, R, an individual. For the 2020 tax year, Q had two shareholders, S and T, both individuals. On June 1, 2023, the IRS mails an FPA to Partnership for Partnership's 2020 year determining $500 of the $1,000 of ordinary loss should be recharacterized as $500 of long-term capital loss and $500 of the ordinary loss should be disallowed. The FPA asserts an imputed underpayment of $400 ($1,000 x 40%) with respect to the $1,000 reduction to ordinary loss and reflecting an adjustment that does not result in an imputed underpayment of a $500 capital loss. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and does not file a petition for readjustment under Section 6234. The time to file a petition expires on August 30, 2023. Pursuant to Section 301.6226-2(b), the partnership adjustments become finally determined on August 31, 2023. On October 12, 2023, Partnership timely files with the IRS statements described in Section 301.6226-2 and furnishes statements to its partners reflecting their share of the partnership adjustments as finally determined in the FPA. The statements to P and Q each reflect a partnership adjustment of a $500 increase in ordinary income and a $250 increase in capital loss in accordance with Section 301.6225-3(b)(6). P takes the adjustments into account under paragraph (e)(3) of this section by timely filing a partnership adjustment tracking report and furnishing a statement to R. Q timely filed a partnership adjustment tracking report, but chooses not to furnish statements and instead must calculate and pay an imputed underpayment under paragraph (e)(4) of this section as well as interest on the imputed underpayment determined under paragraph (e)(4)(iv)(B) of this section. After applying the rules set forth in Section 301.6225-1, Q calculates the imputed underpayment that it is required to pay of $200 ($500 adjustment to ordinary income x 40%). Q also has one adjustment that does not result in an imputed underpayment—the $250 increase to capital loss. Pursuant to paragraph (e)(1) of this section, Q files the partnership adjustment tracking report and pays the amounts due under paragraph (e)(4) of this section by September 15, 2024, the extended due date of Partnership's return for the adjustment year 2023. Pursuant to paragraph (e)(4)(v) of this section, on its 2024 return, the year in which Q made its payment of the imputed underpayment, Q reports and allocates the $250 capital loss to its shareholders for its 2024 taxable year as a capital loss as provided in Section 301.6225-3.

EXAMPLE 9

On its partnership return for the 2020 tax year, Partnership reported a $1,000 long-term capital gain on the sale of stock. Partnership has two equal partners for the 2020 tax year: U (an individual) and V (a partnership). For the 2020 tax year, V has two equal partners: W (an individual) and X (a partnership). For the 2020 tax year, X has two equal partners: Y and Z, both of which are C corporations. On June 1, 2023, the IRS mails a NOPPA to Partnership for Partnership's 2020 year proposing a $500 increase in the long-term capital gain from the sale of stock and an imputed underpayment of $200 ($500 x 40%). On July 17, 2023, Partnership timely submits a request to modify the rate used in calculating the imputed underpayment

under Section 301.6225-2(d)(4). Partnership submits sufficient information demonstrating that $375 of the $500 adjustment is allocable to individuals (50% of the $500 adjustment allocable to U and 25% of the $500 adjustment allocable to W) and the remaining $125 is allocable to C corporations (the indirect partners Y and Z). The IRS approves the modification and the imputed underpayment is reduced to $81.25 (($375 x 15%) + ($125 x 20%)). See Section 301.6225-2(b)(3). No other modifications are requested. On February 28, 2024, the IRS mails an FPA to Partnership for Partnership's 2020 year determining a $500 increase in the long-term capital gain on the sale of stock and asserting an imputed underpayment of $81.25 after taking into account the approved modifications. Partnership makes a timely election under Section 6226 in accordance with Section 301.6226-1 with respect to the imputed underpayment in the FPA for Partnership's 2020 year and does not file a petition for readjustment under Section 6234. The time to file a petition expires on May 28, 2024. Pursuant to Section 301.6226-2(b), the partnership adjustments become finally determined on May 29, 2024. On July 26, 2024, Partnership timely files with the IRS statements described in Section 301.6226-2 and furnishes statements to its partners reflecting their share of the partnership adjustments as finally determined in the FPA. The statements to U and V each reflect a partnership adjustment of a $250 increase in long-term capital gain. V timely files the adjustment tracking report but fails to furnish statements and therefore must calculate and pay an imputed underpayment under paragraph (e)(4) of this section as well as interest on the imputed underpayment determined under paragraph (e)(4)(iv)(B) of this section. On February 3, 2025, V pays an imputed underpayment of $43.75 (($125 x 20% for the adjustments allocable to X) + ($125 x 15% for the adjustments allocable to W)) which takes into account the rate modifications approved by the IRS with respect to Y and Z. V must also pay any interest on the amount as determined in accordance with paragraph (e)(4)(iv)(B) of this section. V must file the adjustment tracking report and pay the amounts due under paragraph (e)(4) of this section no later than September 15, 2025, the extended due date of Partnership's return for the 2024 year, which is the adjustment year.

Adjustments to Partners' Outside Bases & Capital Accounts & a Partnership's Basis & Book Value in Property

As was true in the provisions dealing with a partnership paying the imputed adjustment, the IRS has reserved guidance at Proposed Reg. Section 301.6226-4 for adjustments to partners' outside bases and capital accounts and a partnership's basis and book value in property.

Administrative Adjustment Requests (AARs) by a Partnership

A partnership requesting an AAR (the practical equivalent of an amended return) will generally apply treatments similar to those of changes made when the partnership is under examination by the IRS. Regulation Section 301.6227-1 outlines the rules.

As is explained at Reg. Section 301.6227-1(a), the partnership must first determine if the AAR will result in an imputed underpayment for the reviewed year or if it will not.

If the AAR results in an imputed underpayment, the partnership must either:

- compute and pay the imputed underpayment, taking into account any adjustments allowed under the rules described earlier, or
- elect to use the push-out alternative to paying the imputed understatement, in which case each reviewed year partner takes the adjustment into account in the year the AAR is filed (Reg. Section 301.6227-1(a)).

If the AAR does not result in an imputed underpayment, the reviewed year partners must take the adjustments into account in the year the AAR is filed (Reg. Section 301.6227-1(a)).

A partnership cannot file an AAR merely to change the designation of a partnership representative or designated individual (Reg. Section 301.6227-1(a)).

The regulations describe the limited cases when a partner may file an AAR as follows:

> A partner may not make a request for an administrative adjustment of a partnership-related item except in accordance with Section 301.6222–1 or if the partner is doing so on behalf of the partnership in the partner's capacity as the partnership representative designated under Section 6223.

Time to File an AAR

An AAR cannot be filed until after the original return is first filed with the IRS—that is, you can't use an AAR to effectively have the partnership pay everything at the entity level via an imputed adjustment (Reg. Section 301.6227-1(b)).

Additionally, the regulations note:

> [a]partnership may not file an AAR with respect to a partnership taxable year more than three years after the later of the date the partnership return for such partnership taxable year was filed or the last day for filing such partnership return (determined without regard to extensions). Except as provided in Section 301.6231–1(f), an AAR (including a request filed by a partner in accordance with Section 301.6222–1) may not be filed for a partnership taxable year after a notice of administrative proceeding with respect to such taxable year has been mailed by the IRS under Section 6231. (Reg. Section 301.6227-1(b))

Filing the AAR

An AAR must be filed with the IRS in accordance with the forms, instructions, and other guidance issued by the agency and signed under penalties of perjury by the partnership representative (Reg. Section 301.6227-1(c)(1)).

An AAR must include:

1. [t]he adjustments requested,

2. [i]f a reviewed year partner is required to take into account the adjustments requested under Section 301.6227-3, statements described in paragraph (e) of this section, including any transmittal with respect to such statements required by forms, instructions, and other guidance, and

3. [o]ther information prescribed by the IRS in forms, instructions, or other guidance.

Statements to Be Issued to Reviewed Year Partners

If the reviewed year partners are required to take the adjustment into account on their own returns, the partnership must issue statements that comply with Reg. Section 301.6227-1(d).

In general, the rule provides:

> [i]f a reviewed year partner is required to take into account adjustments requested in an AAR under Section 301.6227-3, the partnership must furnish a copy of the statement described in paragraph (e) of this section to the reviewed year partner to whom the statement relates in accordance with the forms, instructions and other guidance prescribed by the IRS. If the partnership mails the statement, it must mail the statement to the current or last address of the reviewed year partner that is known to the partnership. The statement must be furnished to the reviewed year partner on the date the AAR is filed with the IRS. (Reg. Section 301.6227-1(d)) The statements must contain the following correct information:
>
> i. the name and correct TIN of the reviewed year partner to whom the statement is being furnished;
>
> ii. the current or last address of the partner that is known to the partnership;
>
> iii. the reviewed year partner's share of items as originally reported on statements furnished to the partner under Section 6031(b) and, if applicable, Section 6227;
>
> iv. the reviewed year partner's share of the adjustments as described under paragraph (e)(2) of this section;
>
> v. the date the statement is furnished to the partner;
>
> vi. the partnership taxable year to which the adjustments relate; and
>
> vii. any other information required by forms, instructions, and other guidance prescribed by the IRS. (Reg. Section 301.6227-1(e)(1))

The rules for determining the amounts to be reported on the reviewed year's partner's return are similar to the rules for determining this amount in an examination context. The basic rule provides:

> Each reviewed year partner's share of the adjustments requested in the AAR is determined in the same manner as each adjusted partnership-related item was originally allocated to the reviewed year partner on the partnership return for the reviewed year. If the partnership pays an imputed underpayment under Section 301.6227-2(b) with respect to the adjustments requested in the AAR, the reviewed year partner's share of the adjustments requested in the AAR only includes any adjustments that did not result in the imputed underpayment, as determined under Section 301.6227-2(a).[185]

For items that were not reported originally on the reviewed year return, Reg. Section 301.6227-1(e)(2)(ii) provides:

[185] Reg. Section 301.6227-1(e)(2)(i)

> [e]xcept as provided in paragraph (e)(2)(iii) of this section, if the adjusted partnership-related item was not reported on the partnership return for the reviewed year, each reviewed year partner's share of the adjustments must be determined in accordance with how such items would have been allocated under rules that apply with respect to partnership allocations, including under the partnership agreement.

Finally, Reg. Section 301.6227-1(e)(2)(iii) provides the following:

> *Allocation adjustments*. If an adjustment involves allocation of a partnership-related item to a specific partner or in a specific manner, including a reallocation of an item, the reviewed year partner's share of the adjustment requested in the AAR is determined in accordance with the AAR.

The filing of AAR by the partnership and the acceptance of that AAR by the IRS does not preclude the IRS from examining the partnership and making an adjustment:

> [w]ithin the period described in Section 6235 and the regulations thereunder, the IRS may initiate an administrative proceeding with respect to the partnership for any partnership taxable year regardless of whether the partnership filed an AAR with respect to such taxable year and may adjust any partnership-related item, including any partnership-related item adjusted in an AAR filed by the partnership. The amount of an imputed underpayment determined by the partnership under Section 301.6227-2(a)(1), including any modifications determined by the partnership under Section 301.6227-1(a)(2), may be re-determined by the IRS.

Reserved Guidance for Creditable Foreign Tax Expenditures

The IRS has reserved Proposed Reg. Section 301.6227-1(h) for notice of change to the amount of creditable foreign tax expenditures.

Determining & Accounting for Adjustments Request in AAR

Similar rules as apply for calculating the amounts for adjustments in examinations of a partnership apply to an AAR, as outlined in Reg. Section 301.6227-2. The AAR will compute an imputed underpayment under the same rules as apply generally for an exam.

In addition, most of the modifications that can be requested of the IRS with regard to the administrative adjustment amounts are available to the partnership in an AAR. Allowed AAR modifications are those for:

- tax-exempt partners,
- modifications of applicable tax rates,
- specified passive activity losses,
- limitations or restrictions in the grouping of adjustments,
- certain qualified investment entities,
- tax treaty modifications, or

- as provided in forms, instructions, or other guidance prescribed by the IRS (Reg. Section 301.6227-2(a)(2)).

However, in this case, there is not a request to the IRS for the modification by the partnership. The following is provided by Reg. Section 301.6227-2(a)(2):

1. The partnership is not required to seek the approval from the Internal Revenue Service (IRS) prior to applying the modifications to the amount of any imputed underpayment under paragraph (a)(1) of this section as reported on the AAR; and

2. As part of the AAR filed with the IRS in accordance with forms, instructions, and other guidance, the partnership must—

    a. Notify the IRS of any modification,

    b. Describe the effect of the modification on the imputed underpayment,

    c. Provide an explanation of the basis for such modification, and

    d. Provide documentation to support the partnership's eligibility for the modification.

Adjustments Related to Imputed Underpayment Taken into Account by the Partnership

Unless the partnership elects to use the alternative to the imputed underpayment (the push out election), the partnership must pay the imputed underpayment resulting from an AAR when the partnership files the AAR (Reg. Section 301.6227-2(b)(1)).

Penalties and interest for an AAR are described in Reg. Section 301.6227-2(b)(2).

> The IRS may impose a penalty, addition to tax, and additional amount with respect to an imputed underpayment determined under this section in accordance with Section 6233(a)(3) (penalties determined from the reviewed year). In addition, the IRS may impose a penalty, addition to tax, and additional amount with respect to a failure to pay an imputed underpayment on the date an AAR is filed in accordance with Section 6233(b)(3) (penalties with respect to the adjustment year return). Interest on the imputed underpayment is determined under chapter 67 of the Internal Revenue Code for the period beginning on the date after the due date of the partnership return for the reviewed year (as defined in Section 301.6241-1(a)(8)) (determined without regard to extension) and ending on the date the AAR is filed. See Section 301.6233(a)-1(b). In the case of any failure to pay an imputed underpayment on the date the AAR is filed, interest is determined in accordance with Section 6233(b)(2) and Section 301.6233(b)-1(c).

The regulation provides the following rule for coordination with Chapter 3 and Chapter 4 (withholding):

> *If a partnership pays an imputed underpayment resulting from adjustments requested in an AAR under paragraph (b)(1) of this section, the rules in Section 301.6241-6(b)(3) apply to treat the*

> *partnership as having paid the amount required to be withheld under chapter 3 or chapter 4 (as defined in Section 301.6241-6(b)(2)).*[186]

If the partnership elects to push out the adjustments, then the following rules apply:

> *If a partnership elects under paragraph (c) of this section to have its reviewed year partners take into account adjustments requested in an AAR, the rules in Section 301.6226-2(g)(3) apply to the partnership, and the rules in Section 301.6226-3(f) apply to the reviewed year partners that take into account the adjustments pursuant to Section 301.6227-3.*[187]

Election to Have Adjustment Taken into Account by Reviewed Year Partners

The partnership can elect to have the adjustment taken into account by the reviewed year partners. Regulation Section 301.6227-2(c) provides:

> A partnership makes an election under this paragraph (c) at the time the AAR is filed in accordance with the forms, instructions, and other guidance prescribed by the IRS. If the partnership makes a valid election in accordance with this paragraph (c), the partnership is not liable for, nor required to pay, the imputed underpayment to which the election relates. Rather, each reviewed year partner must take into account their share of the adjustments requested in the AAR that are associated with such imputed underpayment in accordance with Section 301.6227–3. If an election is made under this paragraph (c) with respect to an imputed underpayment, modifications applied under paragraph (a)(2) of this section to such imputed underpayment are disregarded and all adjustments requested in the AAR that are associated with such imputed underpayment must be taken into account by each reviewed year partner in accordance with Section 301.6227–3.

Also, if there is no imputed underpayment calculated due to the AAR, the adjustments must be taken into account by the reviewed year partners.

> If any adjustments requested in an AAR are adjustments that do not result in an imputed underpayment (as determined under paragraph (a) of this section), the partnership must furnish statements to each reviewed year partner and file such statements with the IRS in accordance with Section 301.6227-1. Each reviewed year partner must take into account its share of the adjustments that do not result in an imputed underpayment requested in the AAR in accordance with Section 301.6227-3. (Reg. Section 301.6227-3(d))

Partner Taking AAR Adjustments into Account

If the partnership either elects to have the adjustments taken into account by the reviewed year partners or is required to have those adjustments taken into account by the reviewed year partners, the provisions of Reg. Section 301.6227-3(a) apply.

As Reg. Section 301.6227-3(a) provides:

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[186] Reg. Section 301.6227-2(b)(3)(i)

[187] Reg. Section 301.6227-2(b)(3)(ii)

> Each reviewed year partner (as defined in Section 301.6241-1(a)(9)) is required to take into account its share of adjustments requested in an administrative adjustment request (AAR) that either do not result in an imputed underpayment (as described in Section 301.6225-1(f)(1)) or are associated with an imputed underpayment for which the partnership makes an election under Section 301.6227-2(c). Each reviewed year partner receiving a statement furnished in accordance with Section 301.6227-1(d) must take into account adjustments reflected in the statement in the reviewed partner's taxable year that includes the date the statement is furnished (reporting year) in accordance with paragraph (b) of this section.

The tax must be calculated by the reviewed year partner.

> Except as provided in paragraph (c) of this section, a reviewed year partner that is furnished a statement described in paragraph (a) of this section must treat the statement as if it were issued under Section 6226(a)(2) and, on or before the due date for the reporting year must report and pay the additional reporting year tax (as defined in Section 301.6226–3(a)), if any, determined after taking into account that partner's share of the adjustments requested in the AAR in accordance with Section 301.6226–3. A reviewed year partner may, in accordance with Section 301.6226–3(a), reduce chapter 1 tax for the reporting year where the additional reporting year tax is less than zero. For purposes of paragraph (b) of this section, the rule under Section 301.6226–3(c)(3) (regarding the increased rate of interest) does not apply. Nothing in this section entitles any partner to a refund of tax imposed by chapter 1 of the Internal Revenue Code (chapter 1 tax) to which such partner is not entitled. For instance, a partnership-partner (as defined in Section 301.6241–1(a)(7)) may not claim a refund with respect to its share of any adjustment. (Reg. Section 301.6227-3(b)(1))

Examples

The IRS gives the following two examples (Reg. Section 301.6227-3(b)(2)):

EXAMPLE 1

In 2022, partner A, an individual, received a statement described in paragraph (a) of this section from Partnership with respect to Partnership's 2020 taxable year. Both A and Partnership are calendar taxpayers and A is not claiming any refundable tax credit in 2020. The only adjustment shown on the statement is an increase in ordinary losses. Taking into account the adjustment, A determines that his additional reporting year tax for 2022 (the reporting year) is <$100> (that is, a reduction of $100.) A's chapter 1 tax for 2022 (without regard to any additional reporting year tax) is $150. Applying the rules in paragraph (b)(2) of this section, A's chapter 1 tax for 2022 is reduced to $50 ($150 chapter 1 tax without regard to the additional reporting year tax plus <$100> additional reporting year tax).

EXAMPLE 2

The facts are the same as in Example 1 of this paragraph (b)(2)(i) of this section, except A's chapter 1 tax for 2022 (without regard to any additional reporting year tax) is $75. Applying the rules in paragraph (b)(1) of this section, A's chapter 1 tax for 2022 is reduced by the <$100> of additional reporting year tax. Accordingly, A's chapter 1 tax for 2022 is -$25 ($75 chapter 1 tax without regard to any additional reporting year tax plus -$100 of additional reporting year tax). A owes no chapter 1 tax for 2022, and A may make a claim for refund with respect to any overpayment.

Bankruptcy of the Partnership

Special rules are provided for a partnership in bankruptcy with regard to the new BBA partnership audit regime at Reg. Section 301.6241-2.

The regulation provides the following general description:

> If a partnership is a debtor in a case under Title 11 of the United States Code (Title 11 case), the running of any period of limitations under Section 6235 with respect to the time for making a partnership adjustment (as defined in Section 301.6241-1(a)(6)) and under Sections 6501 and 6502 with respect to the assessment or collection of any imputed underpayment (as defined in Section 301.6241-1(a)(3)) determined under subchapter C of chapter 63 of the Internal Revenue Code (subchapter C of chapter 63) is suspended during the period the Internal Revenue Service (IRS) is prohibited by reason of the Title 11 case from making the adjustment, assessment, or collection until—
>
> (i) 60 days after the suspension ends, for adjustments or assessments, and
>
> (ii) 6 months after the suspension ends, for collection. (Reg. Section 301.6241-2(a)(1))

The regulation also provides that:

> [t]he filing of a proof of claim or request for payment (or the taking of any other action) in a Title 11 case is not be treated as an action prohibited by Section 6232(b) (regarding limitations on assessment). (Reg. Section 301.6241-2(a)(2))

The regulation goes on to note:

> [i]n a Title 11 case, the running of the period specified in Section 6234 (regarding judicial review of partnership adjustments) is suspended during the period during which the partnership is prohibited by reason of the Title 11 case from filing a petition under Section 6234, and for 60 days thereafter. (Reg. Section 301.6241-2(a)(3))

Actions that are not prohibited due to the filing of a Title 11 petition include:

1. an administrative proceeding with respect to a partnership under subchapter C of chapter 63;
2. the mailing of any notice with respect to a proceeding with respect to a partnership under subchapter C of chapter 63, including:
    a. a notice of administrative proceeding,
    b. a notice of proposed partnership adjustment, and
    c. a notice of final partnership adjustment;
3. demand for tax returns;

4. the assessment of any tax, including the assessment of any imputed underpayment with respect to a partnership; and

5. the issuance of notice and demand for payment of an assessment under subchapter C of chapter 63 (but see Section 362(b)(9)(D) of Title 11 of the United States Code regarding the timing of when a tax lien takes effect by reason of such assessment). (Reg. Section 301.6241-2(a)(4).)

Partnership Ceases to Exist

One obvious issue with this change to handling of the exam though even the payment of tax at the partnership level in the exam is what happens if the partnership has gone out of existence before the IRS is able to examine the return. This issue is dealt with in Reg. Section 301.6241-3.

But, in addition to what would normally be viewed as "ceasing to exist," the proposed regulations also define a partnership as ceasing to exist should the partnership prove unable to pay the full imputed adjustment.

The general rule provides that if the IRS determines the partnership ceases to exist before the partnership adjustment takes effect, the partnership adjustment is taken into account by the former partners (Reg. Section 301.6241-3(a)(1)). The partnership itself is no longer liable for any amounts arising from a partnership adjustment (Reg. Section 301.6241-3(a)(2)).

If the partnership has in place an election out of the BBA regime, under IRC Section 6221(b), it will not be required to take a partnership adjustment into account under these special BBA rules. That treatment makes sense since the partnership had elected to be examined under the pre-TEFRA partnership provisions that looked at each partner separately. In that structure the partnership's continued existence isn't really relevant (Reg. Section 301.6241-3(a)(3)).

Ceasing to Exist

The regulations make clear that the determination that a partnership ceases to exist is solely a determination of the IRS.

> "If a partnership ceases to exist, the IRS will notify the partnership and the former partners (as defined in Section (d) of this section), in writing, within 30 days of such determination using the last known address of the partnership and the former partners. A failure by the IRS to send a notification under this paragraph (b)(1) to a former partner of the partnership does not invalidate a determination by the IRS that the partnership ceases to exist. If an audited partnership (as defined in Section 301.6226-3(e)'(1)) ceases to exist, the IRS will also notify the partnership representative of the reviewed year. (Regs. Section 301.6241-3(b)(1))

The regulations define "ceases to exist" as the existence of one of two conditions:

- The partnership terminates within the meaning of Section 708(b)(1)(A).
- The partnership does not have the ability to pay in full the amount due (Reg. Section 301.6241-3(b)(1)).

The regulation defines inability to pay as:

> [f]or purposes of this section, a partnership does not have the ability to pay if the IRS determines that the account due with respect to the partnership is not collectible based on the information the IRS has at the time of such determination. (Reg. Section 301.6241- 3(b)(1))

In addition, the regulation provides that the following are *not* considered conditions under which the partnership ceases to exist:

> (A) valid election under Section 6226 is in effect with respect to any imputed underpayment (as defined in Section 301.6241-1(a)(3));
>
> (B) received a statement under Section 6226(a)(2) (or Section 301.6226-3(e)') and has furnished statements to its partners in accordance with Section 301.6226-3(e')(3); or
>
> (C) the partnership has not paid any amount required to be paid under subchapter C of chapter 63 (Reg. Section 301.6241-3(b)(2)).

The technical termination rule of Section 708(b)(1)(B), deemed not applicable for this purpose, was repealed by the 2017 Tax Cuts and Jobs Act with respect to taxable years beginning after December 31, 2017.

The year in which the partnership ceases to exist depends on which of the two reasons the IRS determined the partnership ceased to exist.

- If a partnership terminates under Section 708(b)(1)(A), the partnership ceases to exist on the last day of the partnership's final taxable year.
- If a partnership does not have the ability to pay, the partnership ceases to exist on the date that the IRS makes a determination under paragraph (b)(1) of this section that the partnership ceases to exist. (Reg. Section 301.6241-3(b)(3))

The regulations provide that the IRS is barred from determining that a partnership ceases to exist with respect to a partnership adjustment after the expiration of the statute of limitations on collections on that adjustment (Reg. Section 301.6241-3(b)(4)).

Consequences Where Partnership Ceases to Exist

The regulation's provisions that allow the IRS to reach outside the partnership and go after partners for an unpaid imputed adjustment are found at Reg. Section 301.6241-3(c).

The regulation first defines what represents full payment of the partnership adjustment by the partnership after which the individual partners will no longer be at risk of having to pay. Regulation Section 301.6241-3(c)(1) provides the following:

Full payment of amounts resulting from a partnership adjustment. For purposes of this section, a partnership adjustment under subchapter C of chapter 63 takes effect when there is full payment of amounts resulting from a partnership adjustment. For purposes of this section, full payment of amounts resulting from a partnership adjustment means all amounts due under subchapter C of chapter 63 resulting from the partnership adjustment are fully paid by the partnership.

The regulation then goes on to deal with a situation where the partnership pays part, but not all, of the adjustment in Reg. Section 301.6241-3(c)(2).

> If a partnership pays part, but not all, of any amount due resulting from a partnership adjustment before the partnership ceases to exist, the former partners (as defined in paragraph (d) of this section) of the partnership that has ceased to exist are not required to take into account any partnership adjustment to the extent amounts have been paid by the partnership with respect to such adjustment. The notification that the IRS has determined that the partnership has ceased to exist will include information regarding the portion of the partnership adjustments with respect to which appropriate amounts have not already been paid by the partnership and therefore must be taken into account by the former partners (described in paragraph (d) of this section) in accordance with paragraph (e) of this section.

Former Partners

Those liable are "former partners," which is a term defined at Reg. Section 301.6241-3(d). Initially, that definition refers to any partner that held an interest in the partnership in the adjustment year (i.e., generally the year when the imputed adjustment became final) (Reg. Section 301.6241- 3(d)(i)). Note that this is a different set of partners than would have been liable for tax had the partnership elected to push out the adjustments under the alternative to the imputed adjustment. In that case, it would have been the reviewed year partners (the partners in the year or years under exam) that would have faced liability for the tax.

If one of the partners of the partnership is itself a partnership, the tax would normally be owed by the partnership in this situation—but if that partner-partnership is deemed by the IRS to itself cease to exist, the partners of that partnership will become liable.

If the adjustment year partner is a partnership-partner that the IRS has determined ceased to exist, the partners of such partnership-partner during the partnership-partner's taxable year— including the end of the adjustment year (as defined in Section 301.6241-1(a)(1)) of the partnership that is subject to a proceeding under Subchapter C of Chapter 63—are the former partners for purposes of this section (Reg. Section 301.6241-3(d)((1)(ii)).

If there are no adjustment year partners (e.g., due to the fact that the partnership terminated prior to the adjustment year and has filed a final return), Reg. Section 301.6241-3(d)(2) provides:

> [i]f there are no adjustment year partners of a partnership that ceases to exist, the term *former partners* means the partners of the partnership during the last taxable year for which a partnership return under Section 6031 was filed with respect to such partnership. For instance, if a partnership terminates under Section 708(b)(1) before the adjustment year and files a final partnership return for the partnership taxable year of such partnership, the former partners for purposes of this section are the partners of the partnership during the partnership taxable year for which a final partnership return is filed.

Calculation of Amounts Due from Former Partners

Although it affects different partners, the actual calculation of amounts due from former partners takes place in a similar fashion to what applies to reviewed year partners when the partnership elects to push out the adjustments by electing the alternative to the imputed underpayment. The calculation

is made by use of statements required to be furnished by the partnership to the partners once the IRS determines the partnership has ceased to exist (Reg. Section 301.6241-3(e)(1)).

The statements are similar to those provided to partners when the partnership elects the alternative to the imputed underpayment (the "push-out" election) except:

1. the adjustments are taken into account by the applicable former partner (as described in paragraph (d) of this section), rather than the reviewed year partners (as defined in Section 301.6241-1(a)(9)), and

2. the partnership must furnish statements to the former partners and file the statements with the IRS no later than 30 days after the date of the notification to the partnership that the IRS has determined that the partnership has ceased to exist.

The IRS has provided a way to deal with the very real possibility that, should the partnership be deemed to cease to exist, there may not be any party who will be able or willing to prepare the required statements. In this case, the IRS itself can step in and send the statements.

Per Reg. Section 301.6241-3(e)(3):

> [i]f any statements required by paragraph (e) of this section are not timely furnished to a former partner and filed with the IRS in accordance with paragraph (e)(2)(ii) of this section, the IRS may notify the former partner in writing of such partner's share of the partnership adjustments based on the information reasonably available to the IRS at the time such notification is provided. For purposes of paragraph (e) of this section, a notification to a former partner under this paragraph (e)(3) is treated the same as a statement required to be furnished and filed under paragraph (e)(2) of this section.

Examples

The IRS provides two examples of the application of this regulation.

EXAMPLE 1

The IRS initiates a proceeding under subchapter C of chapter 63 with respect to the 2020 partnership taxable year of Partnership. During 2023, in accordance with Section 6235(b), Partnership extends the period of limitations on adjustments under Section 6235(a) until December 31, 2025. On February 1, 2025, the IRS mails Partnership a notice of final partnership adjustment (FPA) that determines partnership adjustments that result in a single imputed underpayment. Partnership does not timely file a petition under Section 6234 and does not make a valid election under Section 6226. On June 2, 2025, the IRS mails Partnership notice and demand for payment of the amount due resulting from the adjustments determined in the FPA. Partnership fails to make a payment. On September 1, 2029, the IRS determines Partnership ceases to exist for purposes of this section because the IRS has determined that Partnership does not have the ability to pay under paragraph (b) (2)(i) of this section. Under Section 301.6241-1(a)(1), the adjustment year is 2025 and A and B, both individuals, are the only adjustment year partners of Partnership during 2025. Accordingly, under paragraph (d)(1) of this section, A and B are former partners. Therefore, A and B are required to take their share of the partnership adjustments determined in the FPA into account under paragraph (e) of this section.

EXAMPLE 2

The IRS initiates a proceeding under subchapter C of chapter 63 with respect to the 2020 partnership taxable year of P, a partnership. G, a partnership that has an election under Section 6221(b) in effect for the 2020 taxable year, is a partner of P during 2020 and for every year thereafter. On February 3, 2025, the IRS mails P an FPA that determines partnership adjustments that result in a single imputed underpayment. P does not timely file a petition under Section 6234 and does make a timely election under Section 6226. On May 6, 2025, the IRS mails P an FPA that determines partnership adjustments that result in a single imputed underpayment. P does not timely file a petition under Section 6234 and does not make a timely election under Section 6226. On May 6, 2025, the IRS mails P a notice and demand for payment of the amount due resulting from the adjustments determined in the FPA. P does not make a payment. On September 1, 2025, the IRS determines P ceases to exist for purposes of this section because P does not have the ability to pay under paragraph (b)(1)(ii) of this section. G terminated under section 708(b)(1) on December 31, 2024. On September 1, 2025, the IRS determines that G ceased to exist in 2024 for purposes of this section in accordance with paragraph (b)(1)(i) of this section. J and K, individuals, were the only partners of G during 2024. Therefore, under paragraph (d)(1)(ii) of this section, J and K, the partners of G during G's 2024 partnership taxable year, are the former partners of G for purposes of this section. Therefore, J and K are required to take into account their share of the adjustments contained in the statement furnished by P to G in accordance with paragraph (e) of this section.

Payments Are Not Tax-Deductible

Regulation Section 301.6241-4 provides that payments for taxes, penalties, and interest by a partnership in an examination will be treated as a nondeductible expense as described in IRC Section 705(a)(2)(B).

Dealing with "Non-Partnership Partnerships"

A key issue that has arisen in recent years has involved a question of whether an entity was or was not actually a partnership. The IRS may wish to argue an entity was not a partnership to deny certain benefits that can only arise from a partnership structure. But even if the IRS successfully argues that the entity was not a partnership, the BBA partnership audit regime will still apply. The rules become applicable when an entity files a partnership return regardless of whether it is later found to actually be a partnership (Reg. Section 301.6241-5(a)(1)).

Similarly, even if the finding is not just that there wasn't a partnership but also that the entity itself did not exist, the BBA regime will still apply to the nonentity return (Reg. Section 301.6241-5(b)).

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