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Course Information

Course Title: *Partnership Taxation* #492724

Recommended CPE credit hours for this course

In accordance with the standards of the CFP Board, the National Registry of CPE Sponsors and the IRS, CPE credits have been granted based on a 50-minute hour.

CFP® 7.5 (All states) CFP Board Course ID# 257138
CFP Board sponsor number: 1008.

CPA: 13.5 (All states)
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Sponsor numbers for states requiring sponsor registration:
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Ohio State Board of Accountancy: CPE .51 PSR
Pennsylvania Board of Accountancy: PX 178025
Texas State Board of Accountancy: 009349

EA, OTRP **13** IRS: Qualified Sponsor number: FWKKO.

Course Description

The program will examine tax issues relating to the formation and operation of partnerships. Participants will gain a familiarity with basic areas of partnership taxation so as to recognize a problem and have at hand some practical knowledge for its solution. This course is presented in four practical segments: (1) the formation of partnerships, (2) the basic day-to-day operations of partnerships, (3) the distributions of assets to partners, and (4) the termination of partnership affairs.

Course Content

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Subject Codes/Field of Study
NASBA (CPA), CFP Board of Standards, Inc.: Taxes.
IRS (EA, OTRP): Federal Tax Law.
NAPFA: Taxes

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Learning Assignments & Objectives

As a result of studying each assignment, you should be able to meet the objectives listed below each assignment.

ASSIGNMENT SUBJECT

Chapter 1 Introduction

At the start of Chapter 1, participants should identify the following topics for study:

* Section 761(a)
* Husband-wife partnerships
* Limited partnerships
* Co-tenancies & joint ventures
* Partnership agreements
* Family partnerships
* Publicly traded partnerships
* Advantages & disadvantages
* Complete & partial exclusion elections
* Loss & year limitations

Learning Objectives

After reading Chapter 1, participants will be able to:

1. Determine what constitutes a partnership for federal income tax purposes under §761(a) by:

   a. Recognizing factors for partnership existence identifying co-tenancy status, husband-wife partnerships, and the correct reporting of income and loss;

   b. Identifying the liability of general and limited partners including how such liability might be contained; and

   c. Specifying the factors previously used to determine whether a business was a corporation or a partnership and the factors of the current check-the-box regulations.

2. Recognize the impact of partnership agreements on partners' shares of tax items, specify the requirements of §704(e) for family partnerships, and cite the pros and cons of partnerships to determine when the entity choice is appropriate.

3. Identify the complete or partial exclusion from partnership treatment under §761.

After studying the materials in Chapter 1, answer exam questions 1 to 23.

ASSIGNMENT **SUBJECT**

Chapter 2 **Partnership Income**

At the start of Chapter 2, participants should identify the following topics for study:

* Partners taxed as individuals
* Separately treated items
* Deduction of losses
* Partnership tax return
* Special allocations
* Limitations on the choice of a taxable year
* Closing of the partnership tax year
* Treating partner as a stranger
* Guaranteed payments
* Certain losses disallowed & sales at a gain

Learning Objectives

After reading Chapter 2, participants will be able to:

1. Recognize the allocation of income and deduction among partners, identify when a partnership or its partners are subject to income or estimated tax, determine what constitutes §1402 self-employment taxes, and specify instances where partnerships are viewed as separate entities.

2. Specify the types of separately stated partnership expenses identifying the character of such items and their deduction limitations, and recognize the §704(d) outside basis limitation and its impact on losses.

3. Determine whether a partnership can elect to amortize certain business-related expenses, and specify the elements and requirements of the partnership tax return and the items of deduction to which individuals are entitled.

4. Identify a partnership's year taxable under §706(a) and the allocation of items of income and deduction from the partnership to the partners by:

a. Specifying instances when a partnership generally must conform its tax year to its partners' tax years and the least aggregate deferral of income for each partner whose tax year is different from other partners;

b. Recognizing the availability of the natural business year including the §444 election as it relates to a partnership's tax year identifying its costs and/or benefits; and

c. Determining tax year termination and non-termination events for a partnership.

5. Identify transactions between a partner and a partnership as being between a stranger and a partnership or as guaranteed payments.

After studying the materials in Chapter 2, answer exam questions 24 to 56.

ASSIGNMENT	SUBJECT
Chapter 3	Contributions to Partnerships

At the start of Chapter 3, participants should identify the following topics for study:

* Contribution vs. sale or exchange
* Precontribution gain or loss property
* Allocations as to contributed property
* Character of subsequent gain or loss
* Contribution of services
* Original and adjusted basis of partner's interest
* Effect of liabilities on outside basis
* Partner's share of partnership liabilities
* At-risk rule
* Passive losses

Learning Objectives

After reading Chapter 3, participants will be able to:

1. Recognize the tax-free capitalization rules of §721 by:

   a. Specifying the differences between a contribution and a sale or exchange recognizing the treatment of transfers to investment company type partnerships; and

   b. Identifying when the property taint rules apply and methods of allocation for precontribution gain or loss.

2. Determine a partnership's basis for contributed assets under §723.

3. Specify the taxation of contributed services and strategies to avoid immediate taxation.

4. Determine the original and adjusted basis of an interest acquired by contributing property and/or money under §722.

5. Recognize a partner's loss deduction when the limits on deductions of partnership losses apply by:

   a. Determining amounts at risk under §465; and

   b. Specifying the buckets of income under §469 identifying the impact of passive loss rules.

After studying the materials in Chapter 3, answer exam questions 57 to 79.

ASSIGNMENT	SUBJECT
Chapter 4	Sales & Exchanges of Partnership Interests

At the start of Chapter 4, participants should identify the following topics for study:

* Corn Product Rule
* Importance of capital treatment
* Regulations on the gain on sale of pass-through entities
* Exchanges & transfers
* Unrealized receivables
* Inventory
* Liabilities of partnership
* Inside basis after transfer of a partnership interest
* Gifts
* Abandonment or forfeiture

Learning Objectives

After reading Chapter 4, participants will be able to:

1. Determine capital asset treatment on the sale or disposition of a partnership interest under §741 by:

   a. Recognizing whether the Corn Products Rule applies and the reasoning behind the determination;

   b. Specifying the reasons why capital treatment is important and recognizing the impact of capital gain regulations on sales or exchanges of partnership interests; and

   c. Identifying the tax consequences of exchanges and transfers, and specifying partnership incorporation methods.

2. Recognize the tax treatment of a sale or exchange of a partnership interest where the partnership possesses hot assets (unrealized receivables and inventory), and identify the impact of partnership liabilities in computing both the amount realized on a sale of a partner's interest and the adjusted basis of the sold interest.

3. Specify optional basis adjustment provisions stating how they relate to the general rule for the inside basis after the transfer of a partnership interest, determine the tax consequences of making a gift of a partnership interest, and recognize the unique treatment of partnership interests that are abandoned or foreclosed on with or without related liabilities.

After studying the materials in Chapter 4, answer exam questions 80 to 92.

ASSIGNMENT	SUBJECT
Chapter 5	**Partnership Distributions**

At the start of Chapter 5, participants should identify the following topics for study:

* General nonrecognition rule
* Exceptions to the general nonrecognition rule
* Partner's interest
* Nonliquidating & liquidating distributions

* Special adjustment to basis & mandatory application
* Holding period
* Partnership property
* Proportionate distributions
* Disproportionate distributions
* Effect of distributions of receivables or inventory

Learning Objectives

After reading Chapter 5, participants will be able to:

1. Determine the treatment of distributions of cash or property by a partnership to the partners by:

a. Recognizing the general nonrecognition rule under §731 and specifying exceptions to this general rule;

b. Identifying a partner's basis on either a liquidating or a non-liquidating distribution under §§732 and 733, and specifying instances when a partner may choose a special basis adjustment when receiving a distribution of property other than cash influences how the partner's basis is determined; and

c. Recognizing the tax consequences associated with proportionate and disproportionate distributions, particularly the effect of distributions of receivables or inventory.

After studying the materials in Chapter 5, answer exam questions 93 to 97.

ASSIGNMENT	SUBJECT
Chapter 6	Partnership Liquidations

At the start of Chapter 6, participants should identify the following topics for study:

* Flexible treatment of partnership liquidations
* Types of liquidating distributions
* Section 736(a) payments
* Section 736(b) payments
* Distributions of unrealized receivables or inventory
* Basis of distributed property
* Gain or loss recognition
* Basis adjustment after distributions
* Election - §754
* Additional adjustments required by §754

Learning Objectives

After reading Chapter 6, participants will be able to:

1. Determine ways to liquidate a retiring partner's interest by:

a. Recognizing the types of liquidating distributions and specifying the character and treatment of cash distributions under §736; and

b. Identifying the tax treatment of property distributions in liquidation permitting partnerships to distribute unrealized receivables or inventory.

2. Identify a withdrawing partner's basis when there are distributions in liquidation or in nonliquidation, and specify the requirements of a §754 election identifying additional adjustments required.

After studying the materials in Chapter 6, answer exam questions 98 to 106.

ASSIGNMENT	SUBJECT
Chapter 7	Limited Liability Companies

At the start of Chapter 7, participants should identify the following topics for study:

* Benefits of LLCs
* Advantages of LLCs over C corporations
* Advantages of LLCs over S corporations
* Advantages of LLCs over limited partnerships
* Advantages of LLCs over general partnerships
* Disadvantages of LLCs
* Uses
* Federal tax consequences
* Converting to an LLC from another form of entity
* Local taxes on conversion

Learning Objectives

After reading Chapter 7, participants will be able to:

1. Determine the taxation of limited liability companies recognizing the variety of tax entity choices and their advantages and disadvantages by:

a. Specifying the advantages and disadvantages of an LLC recognizing the advantages of LLCs over C corporations;

b. Identifying the advantages that LLCs have over S corporations and the differences between an LLC and a limited partnership; and

c. Cite the drawbacks of LLCs and their bearing on entity choice.

2. Identify ways to use an LLC and their business-planning opportunities, and specify business ventures that should avoid LLCs.

3. Recognize the federal tax consequences of establishing an LLC by:

a. Determining the role of check-the-box regulations in the entity characterization and identifying self-employment tax regulations and their application to LLC members;

b. Specifying whether an LLC member is at risk for recourse debt and determine the treatment of debt discharge income on an LLC;

c. Identifying the passive loss rules and their association with LLCs and selecting an appropriate method of accounting for an LLC based on its characterization; and

d. Determining how an LLC can designate a tax matters partner for audit purposes.

4. Identify the dangers and tax consequences in converting to an LLC from another form of entity, and recognize the potential assessment of sales and use tax, real property taxes, and real property transfer taxes on entities on conversion to an LLC.

After studying the materials in Chapter 7, answer exam questions 107 to 120.

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Partnership Taxation

By
Danny C. Santucci

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CHAPTER 1

Introduction

Provisions for the taxation of partnerships are in §701 through §761. Under these sections, the partnership files an *information* return (Form 1065). Its income and deductions flow through to and are reflected on, the tax returns of the *partners* (Form 1040). The Code prescribes the consequences of many different sorts of transactions involving partnerships and partners but, allows *substantial flexibility* so that the parties can often achieve the tax results they desire.

Definition of Partnership

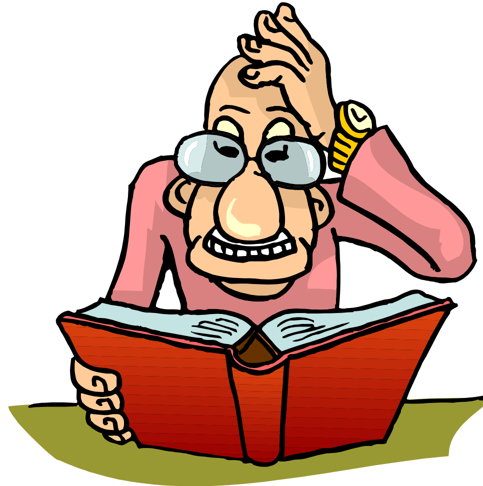
A partnership is a relationship between two or more persons who together carry on a trade or business with each person contributing money, property, labor, or skill, and each expecting to share in the profits and losses of the business.

Note: "Person" when used to describe a partner means an individual, a corporation, a trust, an estate, or another partnership.

Section 761(a)

For income tax purposes the term "partnership" includes a "syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on," and that is *not* a "trust, or estate or a corporation" (§761(a); §7701(a)(2)).

Partnership Definition



- **A partnership is 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 a trust, estate or corporation (§761(a)).**
- **A joint venture is a partnership created to carry out a single business venture. It is subject to the same tax rules as other partnerships.**

Note: The partnership agreement may be modified for a particular tax year after the close of that tax year but not later than the date (not including any extension of time) for filing the partnership return for that year.

Factors

Important factors in deciding when a partnership exists include:

(1) The parties' conduct in carrying out the provisions of the partnership agreement;

(2) The testimony of disinterested persons;

(3) The relationship of the parties;

(4) The abilities and contributions of each; *and*

(5) The control each has over the partnership income and the purposes for which the income is used.

Husband-Wife Partnerships

When spouses carry on a business together and expect to share in the profits and losses, they may be partners whether or not they have a partnership agreement. If so, spouses should report income or loss on Form 1065, (and not on Schedule C, Form 1040, in the name of one spouse as proprietor) and carry their respective shares of the partnership net income or loss to their joint or separate Form(s) 1040. They should include their respective shares of the partnership net income or loss on separate Schedules SE (Form 1040). Doing this will usually not increase their total tax, but it will give *each* spouse credit for social security earnings on which retirement benefits are based.

Election for Husband & Wife Unincorporated Businesses

While an unincorporated business jointly owned by a married couple is generally classified as a partnership for Federal tax purposes, the Small Business and Work Opportunity Tax Act of 2007 permits a "qualified joint venture," whose only members are a husband and a wife filing a joint return, can elect *not* to be treated as a partnership for Federal tax purposes.

Qualified Joint Venture

A qualified joint venture is a joint venture that conducts a trade or business where:

(1) The only members of the joint venture are a husband and wife who file a joint return;

(2) Both spouses materially participate in the trade or business; *and*

(3) Both spouses elect not to be treated as a partnership.

A qualified joint venture, for purposes of this provision, includes only businesses that are owned and operated by spouses as co-owners, and not in the name of a state law entity (including a limited partnership or limited liability company).

Note: The mere joint ownership of property that is not a trade or business does not qualify for the election.

Making the Election

Spouses make the election on a jointly filed Form 1040 by dividing all items of income, gain, loss, deduction, and credit between them in accordance with each spouse's respective interest in the joint venture, and each spouse filing with the Form 1040 a separate Schedule C or Schedule F and, if otherwise required, a separate Schedule SE to report self-employment tax for each spouse.

Spouses electing qualified joint venture status are treated as sole proprietors for federal tax purposes. Using the rules for sole proprietors, an EIN is not required for a sole proprietorship *unless* the sole proprietorship is required to file excise, employment, alcohol, tobacco, or firearms returns. If an EIN is required, the filing spouse should complete a Form SS-4 and request an EIN as a sole proprietor.

Duration

Once the election is made, it can be revoked only with the permission of the IRS. However, the election technically remains in effect only for as long as the spouses filing as a qualified joint venture continue to meet the requirements for filing the election. If the spouses fail to meet the qualified joint venture requirements for a year, a new election will be necessary for any future year in which the spouses meet the requirements to be treated as a qualified joint venture.

Limited Partnerships

Another problem confronting limited partnerships is the required assumption of unlimited liability by the general partner or partners. A variation of the limited partnership that is used to solve this problem is to make the general partner a corporation. The use of limited partnerships in tax shelter transactions has triggered IRS resistance to this device, *particularly* when a corporation serves as the general partner. This organizational scheme allows a flow-through of losses to the limited partners while achieving limited liability for both the limited partners and the stockholders of the corporate general partner.

Taxed as corporations

The IRS initially attempted to tax limited partnerships with *corporate* general partners as corporations under the "Kintner" (based on the *Morrissey* case) regulations (Reg. §301.7701-1). The courts rebuffed the IRS, holding that corporate characteristics did *not* outnumber partnership characteristics. (*Larson v. Commissioner*, 66 T.C. 159 (1976); *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975)) Then, in 1979, the IRS acquiesced in *Larson*. (R.R. 79-106)

Analysis

In *Larson*, the Tax Court made the following determinations:

Continuity

The partnership did not have continuity of life because bankruptcy of the corporate general partner would dissolve the partnership (Reg. §301.7701-2(b)(1)).

Centralized management

The partnership had centralized management. Under the regulations, if the limited partners have substantially all the proprietary interest in the partnership, centralized management exists. However, if the general partner has a significant proprietary interest, the partnership does *not* have centralized management (Reg. §301.7701-2(c)(4)). In *Larson*, the general partner's interest was so subordinated to the other interests that it had no substantial proprietary interest.

Transferability

The limited partners (who had substantially all the interests) had free transferability of their interest in *Larson*. Although they could be transferred only with the general partner's consent, this was *not* considered to be a substantial limitation.

Limited Liability

The partnerships did not have limited liability since the corporate general partner had unlimited liability. Under the regulations, if the general partner either has substantial assets *or* is not a "dummy" (meaning an agent of the limited partners), it has personal liability (Reg. §301.7701-2(d)(2)). In *Larson*, the corporate general partner had no substantial assets, but was not a "dummy." Thus, it had personal liability.

Factor Test Entity Abandoned

Effective January 1, 1997, the Treasury abandoned the four factor test of:

(1) continuity of existence,

(2) centralized management,

(3) limited liability, and

(4) free transferability

and substituted a "check-the-box" system to determine whether an entity was a partnership, corporation or tax "nothing"

Review Questions

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1. For tax purposes, a partnership is essentially a flow-through entity. As a result, a partner's income is reported and taxed on:
   a. Form 1040.
   b. Form 1065.
   c. Form 1120.
   d. Form 8832.
2. A variety of businesses can be treated as a partnership. Which of the following relationships is most often considered a partnership for tax purposes?
   a. a trust that manages funds for a charity.
   b. a corporation that hires independent contractors to perform services.
   c. a joint undertaking created to carry out a business venture.
   d. a co-tenancy of property to share expenses.
3. How can a limited partnership address the unlimited liability issue of the general partner?
   a. give more than 20% of the corporate general partner's stock to the limited partners.
   b. make certain that the net worth of the limited partners at all times is at least $250,000.
   c. make the general partner a corporation.
   d. have a limited partner actively manage the limited partnership.

4. The Internal Revenue Service has mixed reactions to partnerships that have a corporation as a partner. Initially, the IRS challenged the taxation of limited partnerships with corporate general partners:

a. in R.R. 79-106 citing the Larson case.

b. *in Larson v. Commissioner*, 66 T.C. 159.

c. in *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

d. under the Morrissey regulations, Reg. §301.7701-1.

5. In a Tax Court's analysis of whether a business is a corporation or a partnership, what characteristic is present if the limited partners possess substantially all the ownership interest in the partnership?

a. centralized management.

b. continuity of life.

c. free transferability.

d. personal liability.

6. The *Larson* case, 66 T.C. 159, involved a decision analyzing the IRS's business characteristics test. In Larson, the Tax Court determined that the partnership or its partners had:

a. continuity of life.

b. decentralized management.

c. free transferability.

d. limited liability.

Ruling Policies

Prior to *Larson*, the IRS created strict conditions for favorable rulings on limited partnerships.

Corporate General Partner

R.P. 72-13 - Whether such an arrangement is recognized for tax purposes depends upon the application of R.P. 72-13. A limited partnership with a corporation as a sole general partner is recognized as a partnership *only* when the following requirements are met:

1. The limited partners do not own directly or indirectly, individually or in the aggregate, over 20% of the corporate general partner's stock, including the stock of any of its affiliates.
2. If the corporate general partner has an interest in only one limited partnership and total contributions to that partnership are under $2,500,000, the net worth of such partner at all times must be at least 15 percent of that total or $250,000, whichever is *less*. When total contributions are $2,500,000 or more, the net worth of such a partner must be at all times at least 10% of total contributions.
3. If the corporate general partner has an interest in more than one limited partnership, the above net worth requirements are applied separately for each limited partnership.

If taxpayers want the tax benefits of the limited partnership form, it is crucial that the requirements of R.P. 72-13 be fulfilled. One means of assuring that a limited partnership is recognized for tax purposes is to obtain an advance ruling from the IRS. It should be noted that such ruling requests are subject to tight restrictions. See R.P. 74-17, R.P. 89-12, R.P. 91-13, and R.P. 94-46, for additional requirements imposed on the limited partnership with a sole corporate general partner in requesting an advance ruling, R.P. 75-16, which provides a checklist of information required with such ruling requests, and R.P. 87-3, in which the IRS states that it will not issue advance rulings or determination letters regarding special allocation arrangements.

Tax Shelters

For tax shelters, the IRS requires the following *additional* representations for a favorable ruling:

(1) Losses from partnership operations during the first two years will not exceed the amount of equity capital invested in the partnership;

(2) Creditors making nonrecourse loans to the partnership must not have or acquire any interest as a partner; *and*

(3) The general partners must have an interest equal to at least one percent of each item of partnership income or deduction (R.P. 74-17).

Check-the-Box Regulations

In the 1990s, the IRS tired of the factor test and released final regulations for entity classification, commonly known as the check-the-box regulations (Notice 97-1 & TD 8697). The final rules allow entities that are not required to be classified as corporations (e.g., entities that have complied with the formal state law requirements to be organized as "corporations") to elect to be taxed as partnerships or corporations. This simplified regime, which applies to domestic as well as foreign business entities, replaces the existing fact-intensive classification regulations that are based on the historical differences between partnerships and corporations under local law (i.e., the "Kintner regs." under §301.7701).

Among those entities classified as corporations under the final regulations are entities denominated as corporations under applicable law, associations, joint-stock companies, insurance companies, organizations conducting certain banking activities, organizations wholly owned by a state, and organizations taxable under provisions of the Code other than §7701(a)(3).

The regulations also contain a list of foreign entities that are treated as per se corporations. However, any entity that is not required by the regulations to be treated as a corporation is an eligible entity and may choose its classification. In addition, an eligible entity with two or more members can be classified as either a partnership or a corporation. A single member entity can be classified as a corporation or can be disregarded as an entity separate from its owner.

The final regulations have default classifications for eligible entities that will provide most entities with the classification they would otherwise choose. Therefore, in many cases, an actual election will not need to be filed.

For domestic eligible entities, the regulations adopt a passthrough default, and the default for foreign eligible entities is based on whether members of the entity have limited liability.

New Check-the-Box Rules

- **The system applies to all <u>unincorporated</u> business entities**
- **A multiple owner entity is taxed as a partnership unless it elects to be a corporation**
- **A single owner entity can elect to be a corporation or a sole proprietorship**

A foreign entity is classified as a partnership if it has two or more members and at least one of them does not have limited liability. A single-member entity whose owner does not have limited liability will be disregarded as an entity separate from that owner.

An existing entity's "default classification" status is the classification claimed by the entity immediately prior to the effective date of the regulations. An eligible entity's election of its classification may be made on Form 8832, *Entity Classification Election*.

The final regulations are effective as of Jan. 1, 1997. However, under a special transition rule for existing entities, the IRS will not challenge the prior classification of an existing eligible entity or an existing entity on the per se list for periods prior to the effective date of the regulations if:

(1) The entity had a "reasonable basis" for the claimed classification,

(2) The entity and its members recognized the federal tax consequences of any change in the entity's classification within 60 months before the regulations' effective date, *and*

(3) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification was under examination.

The IRS is also notifying taxpayers of the effect of the final regulations on certain revenue rulings and revenue procedures. Effective Jan. 1, 1997, rulings and procedures are now obsolete to the extent that they use the prior classification regulations to differentiate between partnerships and associations. The IRS will publish a list of obsolete documents in the Internal Revenue Bulletin.

Co-tenancies

A joint undertaking merely to share expenses is *not* a partnership. *Mere* co-ownership of property that is maintained and leased or rented is *not* a partnership. However, if the co-owners provide services to the tenants, a partnership exists (Reg. §1.761-1(a)(1)).

Definition of Trade or Business

Mere co-ownership of property that is kept in repair and rented is *not* a partnership. Co-tenants who own rental property and perform only "customary" services for tenants (such as repair of apartments) will not be treated as partners. However, if they furnish additional services (themselves or through an agent), they are treated as a partnership. If they supply such extra services through an *independent contractor*, however, they will *not* be treated as partners (R.R. 75-374; Regs. §1.761-1(a); §301.7701-3(a)).

Since "associates" and an objective to carry on business for joint profit are essential characteristics of an association, the absence of either characteristic will prevent association treatment of any arrangement among co-owners of property for the development of the property for the separate profit of each. Reg. §301.7701-2(a)(2). If it has the required associates and business objective, its association status will hinge on the presence or absence of the other corporate characteristics.

Joint Ventures

As defined in the Code, the term "partnership" includes a joint venture. However, not every joint undertaking is a "partnership" under the definition. Thus, a joint undertaking merely to share expenses is not a partnership. An example would be the case of two or more persons who jointly constructed a ditch merely to drain surface water from their properties. These persons would not be partners (Regs. §1.761-1(a); §301.7701-3(a)).

Investment Clubs

Under the Federal income tax law, an unincorporated organization may be classified as an association and, as such, taxed like a corporation. Hence, a major problem of unincorporated investment clubs is whether they are taxable as partnerships or as associations, this is an important factor in determining the time and manner of returning income from the operations of these organizations. An investment club is generally formed when a group of individuals pool stated funds for investment in securities, usually by pledging regular monthly amounts. It may or may not have a written agreement.

If association status is established, double taxation (tax on organization and stockholders) will apply together with other corporate tax provisions. If there is partnership status, the partners are separately taxed on their distributive shares of the club's investment income.

Thus, if the corporate tax burdens are to be avoided, careful planning is called for in the organization and operation of the club, with full awareness of the factors and circumstances that might impart corporate characteristics to a given organization. These factors must be considered in the formulation of the organizational agreement or bylaws (Reg. §301.7701-2(g) (Example 7)).

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7. Which IRS revenue procedure reflects the requirements that must be met in order to obtain the favorable benefits of a limited partnership?
    - a. R.P. 72-13.
    - b. R.P. 74-17.
    - c. R.P. 87-3.
    - d. R.P. 94-46.
8. Which IRS revenue procedure specifies a checklist of information required with advance ruling requests related to limited partnerships?
    - a. R.P. 75-16.
    - b. R.P. 87-32.
    - c. R.P. 89-12.
    - d. R.P. 91-13.
9. Which of the following is an additional representation required in order for a tax shelter to obtain a favorable limited partnership ruling?
    - a. Creditors providing nonrecourse loans do not have any partnership interest.
    - b. The general partners do not include any husband-wife partnerships.
    - c. The amount of capital invested in the partnership during the first five years must not exceed the losses from partnership operations.
    - d. Limited partners are required to possess an interest equivalent to at least five percent of each item of partnership income or deduction.

10. The check-the-box regulations:
   a. allow entities to elect to be taxed as partnerships or corporations.
   b. require that entities choose a classification by filing an election.
   c. require entities to meet a four-factor test.
   d. were replaced by the Kintner regulations.

11. Notice 97-1 and TD 8697 specify entities that are classified as corporations. Which entity can be classified as a corporation or can be disregarded as an entity separate from its owner?
   a. an insurance company.
   b. a state-owned organization.
   c. a single member entity.
   d. an eligible entity with two or more members.

12. Under the check-the-box regulations, a foreign entity with no requirement to be treated as a corporation:
   a. has a passthrough default.
   b. does not have a default classification.
   c. is treated the same as a domestic entity.
   d. may choose its classification for tax purposes.

13. Which situation will result in double taxation of an investment club?
   a. The club establishes association status.
   b. Members pledge regular monthly amounts.
   c. Partnership status is established.
   d. Stated funds are pooled for investment in securities.

Partnership Agreement

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications can be *oral* or *written*.

Modifications

Partners can modify the partnership agreement for a particular tax year *after* the close of the year, but not later than the date for filing the partnership return for that year. This filing date does *not* include any extensions of time.

Partner's Share of Tax Items

A partner's share of income, gains, losses, deductions, or credits is usually determined by the partnership agreement. However, the partnership agreement or any modification will be disregarded if the allocations to a partner under the agreement do not have *substantial economic effect*. An allocation has substantial economic effect if:

(1) There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners' shares of partnership income or loss *independently* of tax consequences; *and*

(2) The partner to whom an allocation is made actually receives the economic benefit or bears the economic *burden* corresponding to that allocation (§704(b)).

If the allocation does not have substantial economic effect, then the partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership.

Limited Partners

A limited partner is one whose personal liability for partnership debts is limited to the amount of money or other property the partner contributed or is required to contribute to the partnership. Limited partners are not generally considered to materially participate in trade or business activities conducted through partnerships.

Family Partnerships - §704(e)

If a sole proprietor can form a partnership with relatives, part of the income of the business will be taxed in their lower brackets, rather than his or her higher brackets. Thus, family partnerships have long been a popular *income-splitting device* under §704(e). However, if the partnership is not recognized for tax purposes, the tax liability remains with the sole proprietor.

Family partnerships require *special* treatment because of abuses that may arise from the close association of partners. Distributive shares of partnership income may be channeled to low tax bracket partners (e.g., children) who perform little if any, real service for the partnership. When the partner is a child under age 19 of a parent-partner, a substantial portion of the child's distributive income share may be taxed at the parents' tax rate.

A family member will be recognized as a partner in *either* of the following cases:

(1) Capital *is* a material income-producing factor *and* the family member's capital interest[1] is acquired in a bona fide transaction (*even if by gift or purchase from another family member*) in which ownership, dominion, and control are received; *or*

(2) Capital is *not* a material income-producing factor *but* the family member contributes substantial or vital services (§704(e)).

Family, under §704(e), includes only:

(1) Husband and wife,

(2) Ancestors,

(3) Lineal descendants, *and*

(4) Any trusts for the primary benefit of such persons.

Note: Brothers and sisters are *not* included in this list.

Capital Partnerships

If capital is a "material income-producing factor" in the business, the partnership will be recognized for tax purposes, even though the various interests were created by gift and the donees render *no* services. (§704(e))

Gifts & Interfamily Sales

The IRS will closely scrutinize any gift transaction to make sure that the interests were really transferred to the donees. The donees must have actual, bona fide ownership of their interests. The donor *cannot* retain control over the gifted interests, as control would be inconsistent with complete ownership by the donees (See Reg. §1.704-1(e)(2) guidelines).

In addition, when a family member acquires a capital interest by *gift* in a family partnership in which capital is a material income-producing factor, limitations exist on the amount of income that may be allocated to this interest:

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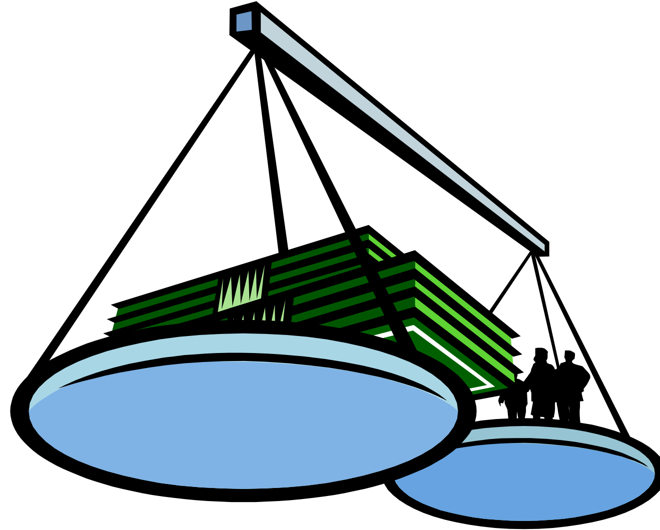
[1] A capital interest in a partnership is an interest in its assets that is distributable to the owner of the capital interest upon the withdrawal of that partner from the partnership or upon the liquidation of the partnership. The mere right to share in the earnings and profits is not a capital interest in the partnership.

Family Partnership Difference



General rule: a taxpayer must contribute capital or services to be recognized as a partner

Family partnership exception: if capital is a material income producing factor, a partner will be recognized even though their interest was received by gift, provided all partners performing services receive reasonable compensation (§704(e))

1. The *donor* of the interest must be allocated an amount of partnership income that represents reasonable compensation for services to the partnership.

Compensation: The donor must receive reasonable compensation or services from the partnership; this rule prevents shifting income equal to the value of the services to the donees (§704(e)(2)). This rule applies even though the family member purchases his or her interest rather than receiving it by gift (§704(e)(3)).

2. The remaining income generally may be divided among the partners according to their agreement for sharing partnership profits and losses. However, the part of the remaining income allocated to the *donee* may not be proportionally greater than the income allocated to the capital interest of the *donor*.

An interest purchased by one family member from another is considered created by gift for allocation purposes (§704(e)(3)).

Example

Dan sold 50% of his business to his son. The resulting partnership had a profit of $50,000. Capital is a material income-producing factor. Dan performed services worth $34,000, which is reasonable compensation, and the son performed no services. The $34,000 must be allocated to Dan as compensation. Of the remaining $16,000 income that is due to capital, at least 50%, or $8,000, must be allocated to Dan since he owns a 50% capital interest, and the son's share of partnership income cannot be over $8,000.

Bipartisan Budget Act of 2015

The Bipartisan Budget Act of 2015 clarified that, in the case of a capital interest in a partnership in which capital is a material income-producing factor, the determination of whether a person is a partner with respect to the interest is made without regard to whether the interest was derived by gift from any other person. Thus, gifting a §704 partnership interest is not an alternative way of determining whether that individual is (or is not) a partner.

Material Use of Capital

If a substantial portion of the partnership's gross income results from the use of capital, such as substantial inventories or investments in plant, machinery, or equipment, it is considered to be a material income-producing factor. If most of the partnership's capital results from borrowings, however, the anticipated allocation of partnership profits might be disallowed.

Ordinarily, capital is *not* a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

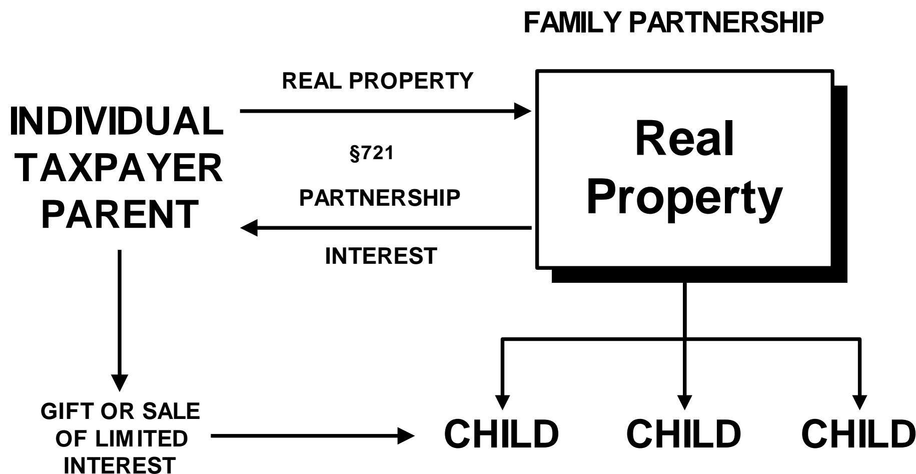
Thus, capital is a "material income-producing factor" in a business that sells (or makes and sells) goods (e.g., a drugstore). Capital is not material in a pure service business (e.g., a real estate brokerage firm). However, some service businesses (e.g., a laundry and dry cleaning business) have sufficient investment in assets so that capital is considered to be material (Reg. §1.704-1(e)(1)(iv)).

To alleviate the uncertainty of whether capital is a material income-producing factor in family partnerships, many taxpayers, and their advisers might be inclined to request an individual ruling from the IRS. Unfortunately, the IRS has indicated it will *not* rule on the issue of materiality (R.P. 87-3).

Minor Children as Partners

When capital is a material income-producing factor and a partnership interest is transferred by gift to a child who is *under age 18* and claimed as a dependent by the parent-partner, the child's distributive share of income in excess of $2,600 (in 2024) will be taxed at the parent's tax rate (§1(g)).

FAMILY LIMITED PARTNERSHIP §704(E)



However, if the child (regardless of age) provides bona fide services to the partnership and the income share is *earned* income, the parent-partner's tax rate will be avoided, and the child's full standard deduction (to the extent of the earned income) can be used.

Non-Capital Partnerships

If capital is not a "material income-producing factor," the standards developed before the enactment of §704(e) govern. Under these rules, the donee *must* contribute capital or services in order to be recognized as a partner (*Commissioner v. Culbertson*, 337 U.S. 733 (1949)).

Publicly Traded Partnerships - §7704

Under §7704, a publicly traded partnership is treated as a *corporation*. A publicly traded partnership is any partnership in which the interests are traded on an established securities market *or* the "substantial equivalent." The IRS provides certain safe harbors that avoid "substantial equivalence" for private placements, transfers not involving trading, de minimis trading, matching services, and redemptions and repurchases.

Grandfathered Exception

In the case of an existing 1987 publicly traded partnership that elects to be subject to a tax on gross income from the active conduct of a trade or business, the rule treating a publicly traded partnership as a corporation does not apply. The tax is 3.5% of the partnership's gross income from the active conduct of a trade or business.

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14. What is the result when a partnership agreement allocation fails to have substantial economic effect?
    a. The partners may modify the agreement for the tax year after the due date of the partnership return for that year.
    b. The partner receiving the allocation also receives its economic benefit or bears its burden.
    c. The partner is classified as a limited partner.
    d. The partner's distributive share of income, gain, or loss is based on the partner's interest in the partnership.
15. When a family member is gifted an interest resulting in ownership, dominion, and control in a family manufacturing partnership the:
    a. family member must be 18 years old.
    b. family member will be acknowledged as a partner.
    c. partnership is publicly traded.
    d. partnership will not be recognized for tax purposes.

16. Under §704(e), who are excluded from the list of eligible family members for family partnership purposes?

a. ancestors.

b. lineal descendants.

c. siblings.

d. spouses.

17. A capital interest may be gifted to a family member in a family partnership in which capital is a material income-producing factor. Under §704(e), what is required when a capital interest is gifted to a family member?

a. An amount of income that represents reasonable compensation for services to the partnership must be allocated to the donor.

b. No partnership services should be provided to the donor.

c. The donor may retain control over the interests.

d. The income allocated to the donee must be proportionally greater than the income allocated to the donor.

18. A material income-producing factor exists when a significant amount of partnership income results from:

a. commissions.

b. compensation for services performed by partnership members.

c. fees.

d. substantial inventories.

19. Which business lacks material income-producing capital?

a. a drugstore.

b. a dry cleaning business.

c. a precision machine shop.

d. a real estate brokerage firm.

Advantages

The advantages of a partnership include:

(1) Income is taxed to the *partners* rather than to the partnership;

(2) Distributed income is *not* subject to double taxation;

(3) Losses and credits generally *pass through* to partners;

(4) The liability of limited partners is normally *limited* as in a corporation;

(5) There can be *more than one* class of partnership interests;

(6) Partners can obtain *basis* for partnership liabilities;

(7) Special allocations *are* permitted; *and*

(8) A partnership can be used to *transfer* value and income within a family group by making family members partners.

Disadvantages

The disadvantages of a partnership include:

(1) The liability of general partners is *not* limited;

(2) Partners are taxed currently on earnings even if the earnings are *not* distributed;

(3) Partners *cannot* exclude certain tax-favored fringe benefits from their taxable income;

(4) Partners may be required to file *numerous* state individual income tax returns for a multistate partnership business; and

(5) In the absence of a business purpose, a partnership must use either a *calendar* year or the same year as the partners who own a majority of the interests in the partnership.

Partnership Advantages

- Partners are taxed not entity
- Income is only taxed once
- Partners can deduct losses
- Special allocations are permitted
- No double taxation on distributions
- Limited liability for limited partners
- Can be used for income splitting
- Partners get basis for entity debt
- Tax- free liquidating distributions
- No unreasonable compensation issue
- Section 754 inside basis election

Partnership Disadvantages

- General Partners Are Personally Liable
- Undistributed Earnings Are Taxed
- Working partners not considered employees but self-employed
- Limited Fringe Benefits For Partners
- Must Use Calendar Year
- Cannot use §1244
- Multistate operation problems

Exclusion from Partnership Treatment - §761

Some partnerships may be excluded completely *or* partially from being treated as partnerships for federal income tax purposes *if* all the partners agree. *If* a partnership is used for *investment* purposes (and *not* for the active conduct of a business), or for the joint production, extraction, or use of property (but not selling services or the property produced or extracted), the partnership might be able to elect *not* to be taxed as a partnership (see Reg. §1.761-2(a) for additional requirements). Instead, each partner merely accounts separately for his or her own share of the income and expenses from the venture (§761(a)).

Complete Exclusion Election

To choose *complete* exclusion, the partnership *must* file a partnership return, Form 1065, for the first year it wishes to be excluded. The return must be filed by the due date (including extensions) for filing the return. File this return with the Internal Revenue Service Center for the area where the organization has its principal office or place of business. This is the same place the partnership would file its annual return if the choice were not being made. The return needs to contain the name or other identification and the address of the organization. The return or statement attached to the return *must* contain the following information:

(1) The names, addresses, and identification numbers of all members of the organization;

(2) A statement that the organization *is* an investing or operating agreement partnership as defined in Reg. §1.761-2(a);

(3) A statement that *all* the members have chosen the exclusion from partnership treatment; *and*

(4) A statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom its provisions may be obtained).

Exclusion from Partnership Treatment

- <u>Some</u> partnerships <u>may</u> be excluded completely or partially from being treated as partnerships for federal income tax purposes if all the partners agree.
- If a partnership is used for <u>investment</u> purposes (and <u>not</u> for the active conduct of a business), or for the joint production, extraction, or use of property (but not selling services or the property produced or extracted), the partnership might be able to elect not to be taxed as a partnership (see Reg. §1.761-2(a) for additional requirements).

Partial Exclusion Election

To choose *partial* exclusion from partnership treatment, an organization must submit a request to the IRS no later than 90 days after the beginning of the first tax year for which partial exclusion is chosen. The request must specify the provisions from which exclusion is sought. It *must* state that the organization qualifies as an investing or operating agreement partnership under Reg. §1.761-2(a) and that the members choose to be excluded to the extent indicated. The partial exclusion is effective only upon *approval* by the Commissioner, subject to any conditions the Commissioner may impose.

Note: The partners of excluded partnerships are not exempt from partnership provisions that impose limits on a partner's distributive share of a partnership loss, or the requirement of a business purpose for the adoption of a tax year for the partnership which is different from that of its required tax year.

Loss & Year Limitations

The partners of excluded partnerships are *not* exempt from partnership provisions that impose limits on a partner's distributive share of a partnership loss, or the requirement of a business purpose for the adoption of a tax year for the partnership that is different from that of its required tax year.

Changing the Choice

The exclusion will *not* take effect if, within 90 days after the formation of the organization, a member notifies the IRS that he or she wants the organization to be treated as a partnership *and* that he or she has notified all the other members of this. This member must notify the other members by registered or certified mail. The choice can only be changed after this 90-day period with the approval of the IRS.

Filing Note

To request approval to change the choice, submit an application to the Commissioner of Internal Revenue, Attention: CC:IND, Washington, DC 20224 within 30 days after the start of the first tax year a partner wants the organization to be treated as a partnership. The choice continues to be in effect unless the organization ceases to qualify as an investing or operating agreement partnership.

In certain circumstances, even though a choice for exclusion was not made, it will be considered made if the members can show that at the time of the formation of the organization they intended to be excluded from partnership treatment.

Review Questions

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20. What is one advantage of a partnership?
    a. Liability of all partners is limited.
    b. Losses and credits generally pass through to partners.
    c. Partners can exclude certain tax-favored fringe benefits from their taxable income.
    d. Partners are able to file one state income tax return for multistate operations.
21. What is one disadvantage of a partnership?
    a. Distributed income is subject to double taxation.
    b. Income is taxed to the partnership.
    c. Taxation is based on earnings even if not distributed.
    d. There may be only one class of partnership interests.
22. Which of the following must be filed for a partnership to elect complete exclusion from partnership treatment for tax purposes?
    a. Form 1065.
    b. Form 1128.
    c. Form 7004.
    d. Form 8082.

23. An entity's request to the IRS for partial exclusion from partnership treatment for tax purposes:

a. must state that the entity does not qualify as an investing or operating agreement partnership.

b. must be made within 120 days of the start of the tax year for which the entity chooses partial exclusion.

c. must identify the provisions for exclusion.

d. will be approved automatically.

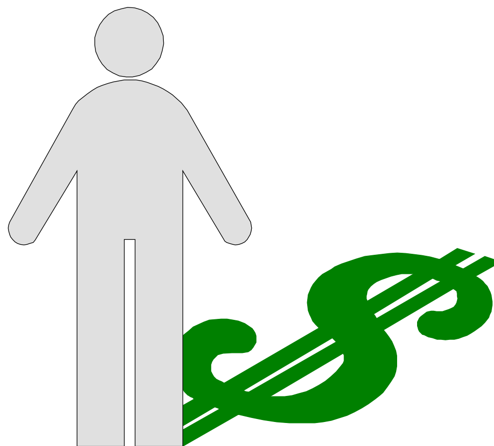
Learning Objectives

After reading Chapter 2, participants will be able to:

1. Recognize the allocation of income and deduction among partners, identify when a partnership or its partners are subject to income or estimated tax, determine what constitutes §1402 self-employment taxes, and specify instances where partnerships are viewed as separate entities.
2. Specify the types of separately stated partnership expenses identifying the character of such items and their deduction limitations, and recognize the §704(d) outside basis limitation and its impact on losses.
3. Determine whether a partnership can elect to amortize certain business-related expenses, and specify the elements and requirements of the partnership tax return and the items of deduction to which individuals are entitled.
4. Identify a partnership's year taxable under §706(a) and the allocation of items of income and deduction from the partnership to the partners by:
   a. Specifying instances when a partnership generally must conform its tax year to its partners' tax years and the least aggregate deferral of income for each partner whose tax year is different from other partners;
   b. Recognizing the availability of the natural business year including the §444 election as it relates to a partnership's tax year identifying its costs and/or benefits; and
   c. Determining tax year termination and non-termination events for a partnership.
5. Identify transactions between a partner and a partnership as being between a stranger and a partnership or as guaranteed payments.

CHAPTER 2

Partnership Income



Partnership income and deductions are allocated among the partners according to their partnership distributive shares as determined by the partnership agreement.

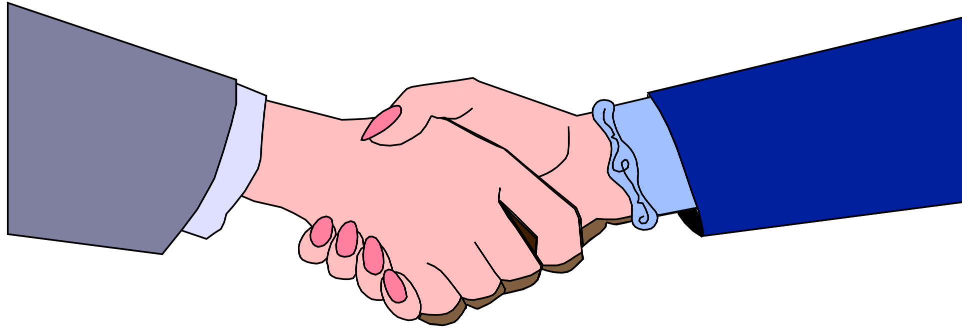
Partners Taxed as Individuals

While a partnership must figure its total income and file Form 1065 which provides information on partnership income or losses for the year, the partnership itself is *not* subject to income tax. A partnership does *not* even make estimated tax payments. However, the *partners* may have to make payments of estimated tax.

The partners are liable for income tax on their distributive share of partnership income in their *individual* capacities. Guaranteed salary or interest payments are included in income in addition to distributive share income. Thus, the partnership is considered an "aggregate" of the partners[1], *not* a separate entity (§701).

[1] The rules that limit the deductions relating to activities not engaged in for profit apply to partners.

Partnership Taxation



- **Partnership is not a Tax Entity**
  - **Exception - Separate Entity for Some Purposes**
  - **Exclusion from Partnership Treatment**
  - **Partnership Tax Return**
    - **Organization & Syndication Fees**
    - **Capitalized Syndication Fees**
    - **Business Start-up Costs**
- **Partners Taxed as Individuals**
  - **Partner's Share of Tax Items**
    - **Partnership Agreement**
      - **Modifications**
    - **Special Allocations - §704(b)**
  - **Individual Returns & K-1s**
    - **Separately Treated Items**
    - **Character of Items & Limitations**
    - **Deduction of Losses - §704(d)**
      - **At-Risk Rule & Passive Losses**

Self-Employment Tax

A general partner's distributive share of income from a partnership is included in figuring net earnings from self-employment (§1402). However, while general partners are subject to the self-employment tax on their distributive share of the partnership's income, limited partners are not (§1402(a)(13)).

> Note: If an individual partner has net earnings from self-employment of $400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040).

Proposed Amendments to Limited Partner Regs

The IRS has issued proposed amendments (REG-209824-96) to the regulations relating to self-employment taxes imposed under §1402. These regulations permit individuals to determine whether they are limited partners for purposes of §1402(a)(13), eliminating the uncertainty in calculating an individual's net earnings from self-employment under existing law.

> Note: These proposed regulations were originally issued in 1997 to provide guidance on defining "limited partner" for self-employment tax purposes. As of 2024, the IRS has not finalized these proposed regulations. They remain outstanding in the proposed form.

The proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity. Thus, the same standards apply when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC.

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual:

(1) Has personal liability (as defined in §301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner;

(2) Has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; *or*

(3) Participates in the partnership's trade or business for more than 500 hours during the taxable year.

If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.

The proposed regulations allow an individual who is not a limited partner for §1402(a)(13) purposes to nonetheless exclude from net earnings from self-employment a portion of that individual's distributive share if the individual holds more than one class of interest in the partnership. Similarly, the pro-

posed regulations permit an individual who participates in the trade or business of the partnership to bifurcate his or her distributive share by disregarding guaranteed payments for services. In each case, however, such bifurcation of interests is permitted only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners under the proposed regulation (without regard to the bifurcation rules) and who own a substantial interest in the partnership. Together, these rules exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership.

Exception - Separate Entity for Some Purposes

For some purposes, the partnership *is* viewed as a *separate* entity:

1. Elections - The method of depreciation for partnership property, general accounting method, depletion, and installment sales *must* be chosen at the *partnership* level, *not* by individual partners[2].

2. Administrative Matters - For audits and judicial review, a partnership is considered a separate entity. A "tax matters partner" represents the partnership in dealing with the IRS. However, partnerships with *ten or fewer* partners (all individuals) can choose to be treated for administrative purposes as an aggregate, *not* an entity (§6221 through §6231).

3. Examination Procedures - Under current examination procedures, the tax treatment of partnership items of income, gain, loss, deduction, credit, etc., is determined at the *partnership* level in a unified partnership proceeding rather than at the individual partner's level. After the proper treatment of a partnership item is determined at this level, the IRS can *automatically* make related adjustments to the tax returns of the partners based on the partners' shares of any adjusted items.

> Note: These examination procedures do *not* apply to partnerships made up of 10 or fewer partners who are individuals (but only if no partner is a nonresident alien) or estates if each partner's share of every partnership item is the same as that partner's share of every other item. However, these small partnerships may make an election to have these procedures apply.

[2] However, the partners, not the partnership, make choices on treatment of foreign and U.S. possessions taxes, certain mining exploration expenses, and income from discharge of indebtedness. The partners may also individually choose to amortize qualifying costs they incur or pay to investigate acquiring their partnership interests.

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24. What are the partners' partnership distributive shares based on?
    a. examination procedures.
    b. regulations.
    c. IRS revenue rulings.
    d. partnership agreement.
25. Under IRS amendments, REG-209824-96, who is considered a general partner?
    a. a partner who lacks authority to contract on behalf of the partnership.
    b. a partner who participates in a manufacturing business less than 100 hours during the year.
    c. a partner who provides services on a limited basis as part of a consulting business.
    d. a partner with limited liability for the debts of or claims against the partnership.

26. Under REG-209824-96, when may an individual exclude a portion of their distributive share from net earnings from self-employment?

a. the partner can freely transfer their interest.

b. the partner has limited liability.

c. the partner has more than one class of the partnership interest.

d. the partner materially participates in the trade or business.

27. Under REG-209824-96, a partner participating in a partnership's business is allowed to bifurcate his or her distributive share:

a. by disregarding guaranteed payments for services.

b. only to the extent the individual's distributive share is more than the distributive share of limited partners.

c. only to the extent the individual's distributive share is less than the distributive shares of majority partners.

d. by limiting participation in the business to less than 100 hours.

28. In some cases, partnerships may be treated as a separate entity. When may a partnership choose to be treated as an aggregate?

a. for administrative purposes, if it has ten or fewer individual partners.

b. for audits and judicial review.

c. for purposes of elections.

d. for selecting an installment sales method, if it has ten or fewer individual partners.

Individual Returns & K-1s

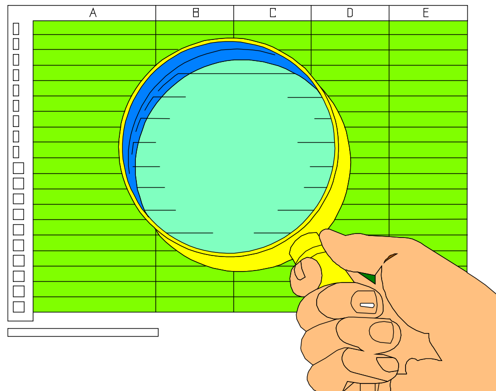
Partners must include in their individual returns their distributive share of partnership income, *whether or not distributed* (§702; Reg. §1.702-1). A partner is taxable on his or her distributive share of partnership income *regardless* of whether

he or she received it or was aware of its existence. Partnership income is taxed when earned; time of distribution is *immaterial*.

The partnership must prepare a Schedule K-1 (Form 1065) for each partner showing that partner's share of each partnership item. Each partner must be given a copy of his or her own Schedule K-1. The partnership must also file Schedule K if over 10 Schedules K-1 are attached to the partnership return.

Partnership Expenses Paid By a Partner

In general, a partner *cannot* deduct partnership expenses paid out of his or her personal funds *unless* required to do so by the partnership agreement. These expenses are usually considered incurred in and deductible by the partnership business. However, if a partner is *required* by the partnership agreement to pay, out of his or her personal funds, an employee who performs part of the partner's duties, the partner can deduct that payment as a business expense.



Separately Treated Items

Each partner counts separately his or her distributive share of certain items of the partnership so that these items are *not* lumped together with all other partnership transactions.

All partners, in determining their income tax, *separately* state their share of a partnership's:

(1) Gains and losses from sales or exchanges of capital assets,

(2) Gains and losses from sales or exchanges of certain property used in a trade or business (§1231), and from involuntary conversions,

(3) Charitable contributions,

(4) Dividends for which corporate partners can claim a deduction,

(5) Certain taxes paid or accrued to foreign countries and to possessions of the United States,

(6) Depletion allowances on partnership oil and gas properties,

(7) Intangible drilling and development costs, *and*

(8) Other items of income, gains, losses, deductions, or credits required by the regulations, such as:

(a) Recoveries of bad debts, prior taxes, and delinquency amounts,

(b) Gains and losses from wagering,

(c) Soil and water conservation expenditures,

(d) Nonbusiness expenses, medical and dental expenses, dependent care expenses, and alimony expenses,

(e) Interest and taxes paid to cooperative housing corporations,

(f) Any items of income, gain, loss, deduction, or credit subject to a special allocation under the partnership agreement that differs from the partnership's usual allocation of taxable income or loss,

(g) Meal expenses paid or incurred by the partnership for a partner, *and*

Note: The 50% disallowance for meals is on the K-1 to show the basis reduction to the partner. No further limitation is applicable on their personal returns.

(h) Any amount that if separately considered by any partner would result in an income tax liability for that partner different from that which would result if the partner did not take the item into account separately.

Note: For example, a credit for the elderly may be available to one or more partners. The partnership must show separately on its return any pensions, annuities, interest, rent, or other income it receives so that a qualifying partner will get full credit.

Note: For figuring the alternative minimum tax on tax preference income, a partner must count separately any distributive share of items of income and deductions that enter into the computation of tax preference items.

The foregoing must be separately stated since they have a *different* effect on each partner depending upon his or her particular tax position. Remaining items of partnership income or deduction are grouped together into a single item and allocated to the partners (§702(a)(8)).

Example

Lazlo and Raoul are equal partners in LR partnership, a self-service coin-operated massage parlor. LR sells a nuclear-powered combination barbecue and tanning rack at a loss of $10,000. Except for this item, LR has a profit of $30,000. During the same year, Lazlo had a $50,000 gain from the condemnation of an apartment house he owned. The $10,000 loss item from the LR partnership is reported separately from

the $30,000 profit. The loss is a §1231 loss and $5,000 will be an ordinary loss to Raoul. However, the other $5,000 will be a capital loss to Lazlo because his §1231 gains ($50,000 from the apartment condemnation) exceed his §1231 losses ($5,000 distributive share from the partnership). The $30,000 profit will be $15,000 ordinary income to Lazlo and $15,000 ordinary income to Raoul.

Character of Items & Limitations

Items of partnership income or deduction have the *same character* in the partner's hands, as they would have if the partner had realized them directly rather than through the partnership. (§702(b); Reg. §1.702-1(b)). Thus a partner's distributive share of the partnership's charitable contributions to organizations qualifying as 50% limit donees under the §170(b)(1)(A) contribution limit rules retains the same character in the partner's hands.

If a partner treats an item *differently* on his or her individual return, the IRS can *automatically* assess and collect any deficiency and penalties that result from adjusting the item to make its treatment consistent with the treatment on the partnership return. However, this does *not* apply if a partner files Form 8082, *Notice of Inconsistent Treatment or Amended Return*, with his or her return identifying the different treatment.

In determining the amount of any deduction or exclusion allowable that is subject to a limitation, a partner must usually *combine* the amounts of any separate deductions or exclusions on his or her individual income tax return with the distributive share of partnership deductions and exclusions before applying the limitation (Reg. §1.702-1(a)(8)(iii)).

Deduction of Losses

If the partnership loses money for the year (i.e., its deductions exceed its income), such losses are *deductible* by the partners. They take the losses into account on the *last day* of the partnership's taxable year.

Outside Basis Limitation - §704(d)

A partner's distributive share of the partnership loss (and depletion on partnership oil and gas properties) is allowed *only* to the extent of the adjusted basis, *before* reduction by the current year's losses, of the partnership's tax year in which the loss occurred. Any share of loss in excess of the partner's adjusted basis is *not* allowed for that year. In short, the amount deductible is limited to the partner's basis for his or her partnership interest - often called "outside basis" (§704(d)).

Thus, if a partner has *no* outside basis (because he or she has not paid for his or her interest and nothing happens to raise basis above zero), he or she *cannot* deduct his or her portion of partnership losses (*Falconer v. Commissioner*, 40 T.C. 1011 (1963)).

Loss Ultimately Deductible

Any loss that is disallowed will be allowed as a deduction for the *following* partnership tax year after the year of the loss, and for *later* tax years, to the extent that the adjusted basis of the partner's partnership interest at the end of the tax year is *more than zero*. Thus, if a partnership loss is not deductible because it exceeds a partner's outside basis, he or she is allowed ultimately to deduct the loss in a later year if his or her basis then rises above zero.

Effect of Losses on Outside Basis - §705

A partner's distributive share of income plus their share of tax-exempt income increase outside basis. Their share of losses decreases it for each of the partnership tax years (§705).

Example

Dan and Daphne run a combined truck stop and ballerina school as equal partners. The partnership and individual returns are filed on a calendar year basis. The partnership lost $20,000 last year due to a tutu shortage. Dan's distributive share of the loss was $10,000. Since the adjusted basis of his partnership interest, before considering his share of last year's loss, was $7,000, Dan could only claim $7,000 of the loss on last year's individual return. The adjusted basis of his interest at the end of the last year was then reduced to zero.

The partnership showed a $24,000 profit this year. Dan's $12,000 share of the profit increased the adjusted basis of his interest by $12,000 (not counting the $3,000 excess loss he could not deduct last year). His return for this year will show individual partnership income of $9,000 (his $12,000 distributive share of this year's profits less the $3,000 loss not allowable last year). The adjusted basis of Dan's partnership interest at the end of this year is $9,000.

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29. A partner's distributive share of partnership income is taxed when:
    a. received.
    b. communicated.
    c. distributed.
    d. earned.
30. What amount of a partner's meal expense is generally deductible?
    a. 0%.
    b. 50%.
    c. 75%.
    d. 100%.
31. If a partner handles a deduction differently on his or her individual tax return compared to the partnership's treatment of the deduction the:
    a. difference in the treatment has no impact on the return.
    b. IRS will likely approve the different treatment.
    c. partner is complying with §702(b).
    d. partner should file Form 8082 with the return.
32. Based on *Falconer v. Commissioner*, what is a consequence of having no outside basis in a year in which the partnership incurs a loss?
    a. The partner may deduct his or her share of the partnership loss.
    b. The loss will always be deductible in the following year.
    c. The partner is denied a deduction for any of the distributive share of loss in that year.
    d. The partner's outside basis is increased only by their share of tax-exempt income.

Partnership Tax Return

The partnership files a return, for information purposes, setting forth all items of income and deduction[3] (Form 1065). However, it is *not* entitled to claim certain deductions to which only individuals are entitled - such as the standard deduction or the personal exemption (§703(a)).

Organization & Syndication Fees - §709

Neither the partnership *nor* any partner is allowed a deduction for amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership (i.e., syndication).

However, the partnership can deduct the lesser of the *organizational* expenses or $5,000 (reduced by the amount the expenses exceed $50,000) in the year the partnership begins business. The partnership can choose to amortize the remaining *organization* fees over a period of *not less than 180 months*. The 180-month period starts with the month the partnership begins business. If the partnership is liquidated *before* the end of the 180-month period, the remaining balance in this account may be deductible as a loss, but only if the 180-month amortization election has been made.

These rules apply to expenses that:

(1) Are incident to the *creation* of the partnership;

(2) Are chargeable to a capital account; *and*

(3) Would be amortized over the life of the partnership if they were incurred for a partnership having a fixed life.

Capitalized Syndication Fees

The special amortization provision does *not* apply to *expenses connected with the issuing and marketing of an interest in the partnership*, such as commissions, professional fees, and printing costs.

Business Start-up Costs - §195

If a partnership begins or acquires a business, it may elect to amortize start-up expenses. To make this election, attach a statement to the partnership return for the tax year in which the amortization period begins. The amortization period starts with the month the partnership begins the business or the month it acquires the business.

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[3] If the partnership uses the accrual method of accounting, its deductions for expenses may depend on economic performance. The economic performance rule is discussed in Publication 538, Accounting Periods and Methods.

> Note: The American Jobs Creation Act of 2004 modified the treatment of start-up and organizational expenditures. As a result, a taxpayer is currently allowed to elect to deduct up to $5,000 of start-up and $5,000 of organizational expenditures in the taxable year in which the trade or business begins. However, each $5,000 amount is reduced (but not below zero) by the amount by which the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively. Start-up and organizational expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period consistent with the amortization period for §197 intangibles.

The return and statement must be filed by the due date of the partnership return (including extensions). The statement must include a description of the expenses, the amount of the expenses, the date the expenses were paid or incurred, the month in which the partnership began or acquired the business, and the number of months in the amortization period.

Once the partnership chooses a period of time for amortizing start-up expenses, and files the election, it may *not* change to a different time period.

Definition

Start-up expenses are amounts paid or incurred in connection with *creating* an active trade or business or for *investigating* the creation or acquisition of an active trade or business. For a partner, start-up expenses are the amounts paid or incurred to *investigate* the acquisition of a partnership interest that is an active trade or business and *not* an investment. A partnership interest is an active trade or business if the partner actively participates in the management of the partnership's trade or business.

Start-up expenses must be of a type that would be allowable as a deduction in the tax year in which they were paid or incurred if they were paid or incurred to expand an *existing* trade or business in the same field.

Filing Requirements

Every partnership must file a return showing its income, deductions, and other information required (§6031). This is an information return and must be signed by *one* partner (§6063). The return must be filed for *every* tax year of the partnership even though it has *no* net income for the year. However, the *first* return is not required to be filed *before* the partnership has income or deductions (Reg. §1.6031-1(a)).

> Note: If a partnership does not carry on business within the United States nor receive income from sources within the United States, it is not required to file a partnership return unless it has U.S. persons as partners who, in determining their tax liability in whole or in part, take into account, either directly or indirectly, partnership items from it.

Due Date of Return

Formerly, Form 1065 had to be filed on or before April 15 following the close of the partnership's tax year if its accounting period is the calendar year. A fiscal year partnership must file its return by the 15th day of the *fourth* month following the close of its fiscal year.

> Note: If a partnership needs more time to file its return, it should file Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*, by the regular due date of its Form 1065. The automatic extension period for time to file is generally 6 months.

However, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, restructured the return due date, effective for tax years beginning after Dec. 31, 2015. As a result, partnerships have to file their returns by the 15th day of the *third* month after the end of the tax year. Thus, entities using a calendar year have to file by March 15 of the following year. In short, the filing deadline for partnerships was accelerated by one month.

Failure to File

A penalty is assessed against the partnership if it is required to file a partnership return and fails to file the return on time, including extensions, or fails to file a return that shows all the information required. The penalty is $195 (adjusted annually for inflation) per *month* (or part of a month) that the partnership return is late or incomplete, up to a maximum of 12 months (§6698(b)). This amount is *multiplied* by the total number of *partners* in the partnership during *any* part of the tax year for which the return is due.

The penalty will *not* be imposed when the partnership can show that failure to file a complete or timely return is due to *reasonable cause*. Certain small partnerships (with 10 or fewer partners) will meet this reasonable cause test if:

(1) Each partner is a natural person (other than a nonresident alien) or an estate;

(2) Each partner's share of each partnership item is the same as that partner's share of every other item; *and*

(3) All partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.

This penalty is assessed against the *partnership*. However, each partner is *individually* liable for the penalty to the extent that the partner is liable for partnership debts generally.

Failure to Furnish Copies to Partners

The partnership is required to furnish copies of Schedules K-1 (Form 1065) to the partners. A penalty of $50 for each statement not furnished will be assessed against the partnership *unless* the failure to furnish copies was due to reasonable cause and not willful neglect (§6695(a)).

Review Questions

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33. Which of the following statements is correct regarding the treatment of fees incurred for the marketing of a partnership interest?
    a. The partnership and partner are allowed a deduction for the fees.
    b. Only the partnership is allowed a deduction for the fees.
    c. Only the partner is allowed a deduction for the fees.
    d. The partnership and partner are not allowed a deduction for the fees.

34. Under §709 what is the minimum period certain organization fees may be amortized over?

a. 60 months.

b. 120 months.

c. 180 months.

d. 240 months.

35. Under §195, a partnership may elect to amortize start-up expenses. What must the partnership do to make this election?

a. attach a statement to the partnership return.

b. attach the partnership agreement to the return.

c. file Form 1065.

d. file an amended Form 1065.

36. Under the American Jobs Creation Act of 2004:

a. A taxpayer may elect to deduct up to $5,000 of start-up costs.

b. A taxpayer may not elect to deduct organizational expenditures.

c. The deductible organizational cost amount is reduced by the amount the cumulative costs exceed $100,000.

d. Start-up and organizational costs are amortized over a 30-year period.

37. Which of the following is a requirement of a partnership information return?

a. The return must be filed by each partner.

b. The return must be filed even if the partnership has no income or deductions in its first year.

c. The return must be filed for every tax year of the partnership.

d. The return must be signed by all partners.

38. What amount of penalties may the IRS assess a partnership that filed its partnership return two months after the due date of the return?

a. $50 multiplied by the total number of partners.

b. $390 multiplied by the total number of partners.

c. $150 multiplied by the total number of partners.

d. $200 multiplied by the total number of partners.

39. If a partnership with ten or fewer partners can prove that there is reasonable cause for their inability to file a complete partnership return, the penalty will be waived. Which of the following would satisfy one element of the reasonable cause test?

a. All partners are nonresident aliens.

b. Most partners have fully reported the partnership items on their timely filed tax returns.

c. The prior year's partnership return was complete and filed timely.

d. Every partner's share of each partnership item is the same as that partner's share of all other items.

Special Allocations - §704(b)

All items of income and deduction are divided between the partners subject to the provisions of the partnership agreement (§704(a) & (b)(1)). However, if the allocation has *no substantial economic effect*, it will be *disregarded* and the item will be allocated in accordance with the partner's interest in the partnership (§704(b); Reg. §1.704-1(b)(1)(i)).

Economic Effect

The "substantial economic effect" test applies to any allocation of specific items of income, gain, loss, deduction, and credit as well as to the "bottom line" allocation of taxable income or loss. For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. In other words, there must be an *economic* benefit or burden to a partner that matches the *tax* allocation.

"Substantial Effect"

The economic effect must be "substantial" to be honored for tax purposes. This means that the economic effect is weighed against the tax savings produced by the allocation. If the economic effect seems insignificant or transitory and the tax savings are large, the special allocation would be ignored (Reg. §1.704-1(b)(2)(iii)). The basic requirements for substantial economic effect are:

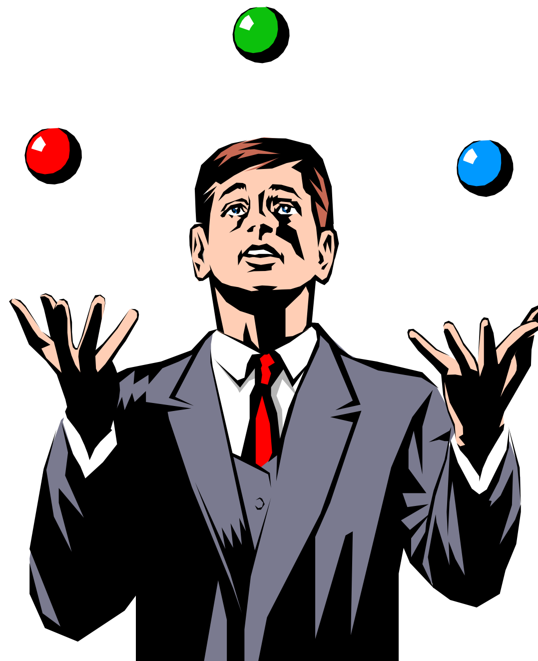
(1) A written provision in the partnership agreement reflecting the terms of §704(b),

(2) The use of *capital accounts* to keep track of the special allocations among partners,

(3) The *restoration* of any negative capital accounts *prior* to termination of the partnership, *and*

(4) Liquidating distributions *must* be made pursuant to the ratio of the capital accounts.

Economic Effect Requirements



❶ **Have a written provision in the partnership agreement reflecting §704(b)**

❷ **Use capital accounts to keep track of special allocations**

❸ **Prior to termination of the partnership, there must be deficit restoration**

↕

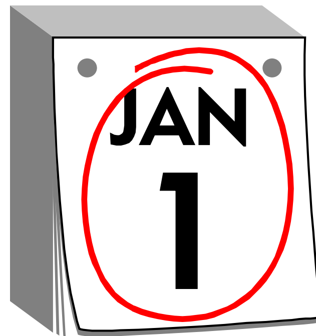
❹ **Liquidating distributions must be made in the ratio of capital accounts**

This means that partnership *capital accounts* must reflect the tax allocations and that, upon liquidation of the partnership, the distributions to partners must be determined by those capital accounts. If a partner has a deficit balance in his or her capital account, the partner must be obligated to *restore* the amount of that balance to the partnership by the end of the taxable year (Reg. §1.704-1(b)(2)(ii)).

Example

Lazlo and Raoul are equal partners in a partnership that owns an apartment house full of flight attendants down at the beach, however, Lazlo is Republican and in a much higher tax bracket. The partnership agreement specially allocates all depreciation to Lazlo. The current depreciation deductions reduce Lazlo's taxable income but they also reduce his partnership capital account, which determines the actual amount he receives when the partnership is dissolved. A partner must pay back a negative balance in their capital account at the time of dissolution. This allocation has substantial economic effect.

However, if the agreement provided that when the building was sold, Lazlo would be entitled to receive half of the assets of the partnership regardless of the balance in his capital account. The allocation of depreciation would have no economic effect and would be ignored for tax purposes (Orrisch v. Commissioner, 55 T.C. 395 (1970)).



Year Taxable - §706(a)

The various items of income and deduction from the partnership are allocated to the partners on the *last day* of the partnership's taxable year (§706(a)).

Example: If the partnership's taxable year ends on January 31, 2017, the partnership's items of income and deduction from the year that began on February 1, 2017, and ended on January 31, 2018, would appear in the tax returns of the partners for 2018, not 2017. Thus, they have deferred tax on 2017 income until 2018.

Limitation on Choice of Taxable Year

A partner's ability to take advantage of deferral is *limited*. Partnerships are generally required to use the *required tax year* (normally the calendar year) *unless* a business purpose exists for the adoption of another year (§706(b)(1)) *or* an election under §444 is available.

Required Tax Year

A partnership generally must conform its tax year to its partners' tax years as follows:

1. If one or more partners own an interest in partnership profits and capital of *more than 50%* (a majority interest), the partnership must use the tax year of those partners[4].
2. If there are no partners who own a majority interest *or* if the partners who do own a majority interest do *not* have the same tax year, the partnership is required to use the tax year of its principal partners. (A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.)
3. If no tax year is established by either the majority partners or the principal partners, the partnership must generally use a tax year that results in the least aggregate deferral of income to the partners. This will almost always be the same as the tax year of at least one of the partners.

The *least aggregate deferral of income* is determined by comparing the deferral that would result to all the partners if one of the partner's tax years were the partnership's tax year. A computation must be made for each partner whose tax year is different from the other partners, as follows:

1. Determine the number of months of deferral using one partner's tax year[5].
2. Multiply the deferral period found in (1) by each partner's profit interest in the partnership for the year.
3. Add the amounts figured in (2) to get the aggregate (i.e., the total amount of) deferral.
4. Repeat steps (1) through (3) for each partner's tax year that is different from the other partners' years.

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[4] This does not apply unless the tax year of the partner (or partners) with the majority interest has been the same for the 3 tax years (or a shorter period if the partnership has not been in existence for 3 years) ending on or before the beginning of the tax year of the partnership. This rule applies even if the majority interest was not owned by the same partner(s) for the preceding tax years.

[5] The months of deferral are found by counting the months from the end of the partnership's proposed tax year forward to the end of that partner's actual tax year.

The partner's tax year that results in the *lowest* aggregate number is the tax year that *must* be used by the partnership. If more than one year qualifies as the tax year that has the "least aggregate deferral of income," the partnership may choose any year that qualifies. However, if one of the tax years that qualify is already the partnership's existing year, the partnership must retain that year.

Generally, the determination is made at the beginning of the partnership's current tax year. However, the IRS can require the partnership to use another period if it decides that there was a transfer of partnership interests principally for qualifying for a specific tax year.

Example

Attack, Inc. and Plunder, Inc. are 60/40 partners in Destroy-All, a war toys manufacturing partnership. Attack has a fiscal year ending May 30. Plunder has a fiscal year ending November 30. Because Attack owns more than fifty percent of the partnership interests, Destroy-All must use a May 30 year. However, if Attack and Plunder were 50/50 partners, Destroy-All would be required to use the calendar year.

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40. Which of the following is one requirement for determining substantial economic effect?

    a. The partners have an oral agreement that reflects the terms of §704(b).

    b. Capital accounts are used to track special allocations.

    c. Liquidating distributions are divided equally.

    d. Negative capital accounts are permitted indefinitely.

41. Which of the following is the highest level consideration for the partnership using the tax year of a partner?

    a. At least one partner uses a fiscal year.

    b. At least one partner owns a majority interest in partnership profits and capital.

    c. The principal partners do not have the same tax year.

    d. The partnership has changed its tax year in the past.

42. A partnership would use a tax year based on the analysis of deferred income to the partners when:

    a. neither the majority partners nor the principal partners establish a tax year.

    b. a partner has less than 50% interest in the partnership.

    c. a principal partner chooses a tax year other than the calendar year.

    d. one of the principal partners has not chosen a tax year.

43. How is the least aggregate deferral of income determined?

    a. The partners' profit interests in the partnership are added together.

    b. Deferrals that would result to all partners if another partner's tax year was the partnership's tax year are compared.

    c. The number of months of deferral using the majority partner's tax year is determined.

    d. Each partner's profit interest in the partnership for the year is divided by the deferral period.

Business Purpose - §706(b)

A partnership may use a taxable year other than that prescribed by the preceding rules *if* it shows a *business purpose* for doing so to the IRS (§706(b)(1)(C)).

Rev. Proc. 87-32

A partnership may use the "expeditious approval" provisions in R.P. 87-32 to request retention of, or a change to, a tax year that is a natural business year. The natural business year is determined by the "25% test," using the method of accounting used for the tax returns for each year involved as follows:

1. Compute gross receipts from sales and services for the *most recent* 12-month period that ends with the last month of the requested fiscal year.
2. Compute the gross receipts for the *last* 2 months of the 12-month period.
3. Divide the amount determined in (2) by the amount in (1).
4. Make the same computation in (1)-(3) using the *two* 12-month periods immediately *before* the period used in (1).

25% Seasonal Income Test

- To use the natural business year the partnership must show that:
  - More than 25% of the gross receipts for the year occur during the last two months of the 12 month period being considered for the natural business year, and
  - Such has occurred for the preceding three 12-month periods (R.R. 87-32)
- The natural business year is not available to a partnership that:
  - Changed its accounting method within the last 6 years; or
  - Is involved in a tiered partnership arrangement.

Highest Average Requirement

If *each* of the *three* results equals or exceeds 25%, the fiscal year is the natural business year. If a partnership using these computations qualifies for more than one business year, the fiscal year producing the *highest* average of the three percentages is the natural business year.

47-Month Exclusion

If a partnership does not have *at least* 47 months of gross receipts (which may include a predecessor organization's gross receipts), it can*not* use this procedure to obtain permission to use a fiscal year.

Restrictions

If the "25% test" is met, the partnership must satisfy the following conditions to qualify for expeditious approval:

1. The partnership must file a tax return for the short period (if changing its tax year) or for the retained tax year by the due date (including extensions) of the return.
2. If a short period is required, it must begin on the day following the close of the old tax year and end on the day before the first day of the new tax year.
3. The partnership's books must be closed as of the last day of the short period.
4. The partnership's books and records, including financial reports and statements for credit purposes, must be kept based on the retained or new tax year.

Form 1128

A partnership changing its tax year under these provisions must file Form 1128, *Application for Change in Accounting Period*, by the 15th day of the second calendar month following the close of the short period.

Filing Note

Form 1128 should be filed with the Director of the Internal Revenue Service Center where the partnership files its Form 1065. The envelope should be marked "Attention: ENTITY CONTROL." In addition, the first page of Form 1128 should have at the top of the statement, "FILED UNDER REV. PROC. 87-32." Additional information must be attached to the form indicating whether the partnership is retaining or changing its tax year and the amount of gross receipts for the most recent 47 months.

In addition, a partner must sign a statement, under penalties of perjury, that the partnership "is retaining (or changing to) a tax year that coincides with its natural business year as defined in section 4.01(1) and as verified by its satisfaction of the requirements of section 4.02(1) of Rev. Proc. 87-32"

Section 444 Election

Under §444 of the Internal Revenue Code, *certain* partnerships may elect to use a tax year that is different from their required tax year. A partnership is eligible to make a §444 election if it meets the following conditions:

1. It is not a member of a tiered structure unless all the members of the tiered structure have the same tax year[6];
2. It has not made a §444 election before; and
3. It does not choose a tax year where the deferral period, discussed under Limitations on Changing a Tax Year below, is *more than 3 months*, or the deferral period of the tax year being changed if this period is shorter.

A partnership should not make a §444 election when it wants to establish a business purpose for having a tax year different from its required year.

Limitations on Changing a Tax Year

A partnership can elect to change to a tax year only if the deferral period of the tax year being elected is:

(1) 3 months or less, *or*

(2) The deferral period[7] of the tax year that is being *changed* (if this period is *shorter*).

Change Example

BD Partnership uses a calendar tax year that is also its required tax year. Because BD's deferral period is zero, BD is not able to make a §444 election.

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[6] A tiered structure, for this purpose, occurs when a partnership directly owns any portion of another partnership, S corporation, or personal service corporation or any portion of the partnership itself is owned by one of these entities unless certain de minimis tests are met.

[7] For a partnership that wants to adopt or change its tax year by making a §444 election, the deferral period is the number of months between the end of the elected tax year and the close of the required tax year.

Adopt Example

Octopus, Industries, a newly formed partnership, began operations on December 1, 2024 Calendar year partners own octopus. Octopus wants to make a §444 election to adopt a September 30 tax year. Octopus's deferral period for the tax year beginning December 1, 2024, is 3 months (September 30 to December 31). Octopus may make a §444 election to use a September 30 tax year.

Making the Election - Form 8716

A partnership makes a §444 election by filing Form 8716, *Election to Have a Tax Year Other Than a Required Tax Year*, with the Internal Revenue Service Center where it files its returns. Form 8716 must be filed by the *earlier* of:

(1) The due date (not including any extensions) of the income tax return that results from the §444 election, *or*

Example

Dowee, Stickem & How, a law partnership, began operations on September 10, 2024, and qualifies to make a §444 election to use a September 30 tax year for its tax year beginning September 10, 2024. The partnership must file Form 8716 by January 15, 2025, which is the due date of the tax return for the period September 10, 2024, to September 30, 2024.

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(2) The 15th day of the fifth month following the month that includes the first day of the tax year for which the election is effective.

Example

The facts are the same as in the example above, except that Dowee, Stickem & How began operations on October 20, 2024. The partnership must file Form 8716 by March 15, 2025, the 15th day of the fifth month following the month which includes the first day of the tax year for which the election will be effective.

A partnership must also attach a copy of Form 8716 to its Form 1065 for the first tax year for which the election is made.

Back-Up Election

However, when a partnership requests permission to change to a tax year based upon a business purpose, it may also, if qualified, file a backup §444 election.

Filing Note

A back-up election is made by filing Form 8716 using the rules discussed before by typing or printing legibly "BACK-UP ELECTION" at the top of Form 8716.

If the business purpose tax year is denied, the partnership may then activate the back-up election by filing the required return and making the required payment, *if* a payment is due.

Required Payment

A partnership must make a "required payment" for any tax year in which a §444 election is in effect and the required payment amount is over $500. A partnership should use the worksheet in the instructions for Form 1065 to figure the amount of the required payment and report it on Form 720, *Quarterly Federal Excise Tax Return*. The worksheet must be attached to Form 720.

If the required payment is over $500, it is paid when Form 720 is filed. The payment can also be made with FTD deposits. If the required payment is $500 or less, no payment is made, but Form 720 must be filed showing a zero amount.

When to File

Form 720 must be filed and the required payment made (or zero amount reported) by May 15 of the calendar year following the calendar year in which the applicable election year begins.

Termination of Election

A §444 election ends when a partnership:

(1) Changes to its required tax year,

(2) Liquidates,

(3) Willfully fails to file the returns and make the payments due, *or*

(4) Becomes a member of a tiered structure unless all members of the tier have the same tax year.

Filing Note

If an election terminates, the partnership must file a short-period return. It must type or legibly print at the top of the first page of its short period return: "SECTION 444 ELECTION TERMINATED."

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44. Under R.P 87-32, what percentage of gross receipts must occur in the last two months of the year under consideration to satisfy a requirement of the natural business year test?
    - a. More than 15%
    - b. More than 20%
    - c. More than 25%
    - d. More than 30%

45. What minimum period of gross receipts must a partnership have in order to qualify for the natural business year test under R.P.87-32?

a. 25 months.

b. 36 months.

c. 47 months.

d. 60 months.

46. Which of the following would satisfy a requirement of a partnership making a §444 election?

a. Some members of the tiered partnership structure have the same tax year.

b. The partnership selects a tax year where the deferral period is more than 3 months.

c. The partnership has not previously made such an election.

d. The partnership wants to establish a business purpose for having a different tax year.

47. Eligible partnerships must file a tax form to make a §444 election. Which form should these partnerships file?

a. Schedule M-3.

b. Form 1065-B.

c. Form 8716.

d. Form 8804-C.

48. What form should a partnership use to report a required tax payment for a year with an effective §444 election?

a. Form 720.

b. Form 1065.

c. Form 8805.

d. Form 8813.

Closing of Partnership Year

When a partnership terminates, the taxable year *closes* to all partners and all income or loss to the date of termination must be reflected on the returns of the partners for the year *in which the termination occurs*. Furthermore, upon a "termination," the assets of the partnership are *deemed distributed* to the partners; if they continue the partnership, this would be treated as a *contribution* of the assets to a *new* partnership (Reg. §1.708-1(b)(1)(iv)).

Example

The taxable year of Fender, Bender & Whiplash, a law partnership ends on January 31, 2024. However, the partnership is terminated on December 1, 2024. The partners must reflect on their 2024 returns both the results for the twelve months ending January 31, 2024, and also the results for the ten months between February 1, and December 1, 2024. The result is to telescope twenty-two months of profits into a single taxable year because both the tax year of the partnership and the year of its termination are within the individual partner's tax year.

Events That Terminate Partnership - §708(b)

Discontinuance of Business

If *no* part of the business or the financial operation of the partnership continues to be carried on by any of its partners, the partnership is terminated (§708(b)(1)(A)). However, if one partner of a two-partner firm dies or retires, the partnership *remains* in existence until *all* payments due to that partner or the estate have been made (Regs. §1.736-1(a)(6) & §1.708-1(b)(1)(i)).

Winding Up

If the partnership sells its assets *but* is still in the process of winding up, it is *not* terminated, although it may be considered dissolved for *state* law purposes.

Closing of Partnership Year

- When a partnership terminates, the taxable year closes as to all partners and all income or loss to the date of termination must be reflected on the returns of the partners for the year in which the termination occurs.
- Furthermore, upon a termination, the assets of the partnership are deemed distributed to the partners;
- If thereafter the partners continue the partnership, this would be treated as a contribution of the assets to a new partnership (Reg. §1.708-1(b)(1)(iv))

Sale of 50% or More Interest Technical Termination Repealed

Formerly, the sale or exchange of a partnership interest could result in the termination of the entire partnership. If during a *twelve-month period*, there was a sale or exchange of *fifty percent or more* of the partnership interest in capital and profits, the partnership terminated as to all partners (§708(b)(1)(B). As a result, the partnership's tax year ended and income bunching could take place because all partners were required to report their share of profits up to the date of termination.

> Note: The Service has issued final regulations (T.D. 8717) under §708(b)(1)(B) relating to the termination of a partnership on the sale or exchange of 50% or more of the total interest in partnership capital or profits. The final regulations apply to terminations of partnerships under §708(b)(1)(B) occurring on or after May 9, 1997.

> Comment: A gift of the partnership interest did *not* trigger this result, nor did the death of a partner and a bequest of the interest to survivors (Reg. §1.708-1(b)(1)(ii); *Maxcy v. Commissioner*, 59 T.C. 716 (1973)).

However, this technical termination rule of §708(b) has been repealed (§708(b)(1)). Thus, the partnership is treated as continuing even if more than 50% of the total capital and profits interests of the partnership are sold or exchanged, and new elections would not be required or permitted.

The existing rule of §708(b)(1)(A) that a partnership is considered terminated 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 has not changed.

Events That Do Not Close the Year - §706(c)

Generally, the taxable year of a partnership does not close by reason of the death of a partner, the entry of a new partner, the liquidation of a partner's interest, or the sale or exchange of a partner's interest (§706(c)(1); however see §708, concerning the sale or exchange of 50% or more of the interests).

Sale of Individual Partner's Interest

When a partner sells or exchanges his or her entire interest in a partnership or his or her partnership interest is liquidated, the partnership year closes *only as to him or her* as of the sale date. He or she will reflect in his or her tax return for the year in which the sale occurs his or her share of all partnership items accruing up to that time (§706(c)(2)(A)). If the partnership uses an IRS-approved business purpose fiscal year and the partner uses a calendar year, income bunching may take place, because the selling partner's distributive share of partnership income for the closed tax year is reported in that partner's tax year that includes the sale date.

Death of Partner

Since the death of a partner does *not* close the year for the partner *or* the partnership, a deceased partner's distributive share of income for the year of death is *not* reported on that partner's final tax return. Instead, the entire amount is reported on the tax return of the partner's *estate*. It is "income in respect of a decedent," meaning that it is fully taxable (if a profit) or deductible (if a loss). (§706(c)(2)(A)(ii); *Hesse v. Commissioner*, 74 T.C. 1307 (1980))

Buy/Sell Exception

When the partnership agreement *requires* a sale of the partnership interest to the partnership *on the date of death*, the partnership year would close for the deceased partner on his or her death and the income or loss *up to the date of death* would be reportable on the *partner's* final return (Reg. §1.706-1(c)(3)(iv)).

Change for Closing of Partnership Taxable Year

The taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise.

Note: The provision is effective for partnership taxable years beginning after December 31, 1997.

Admission of New Partners - §706(d)

When there is a change in partnership interests during the year (as by admission of a new partner), the various items of income and deduction must be *allocated* between the partners for the periods *before* and *after* the change takes place (§706(c)(2)(B)). Such allocations must be done based on *time*. Retroactive allocations to new partners are *forbidden* (§706(d)(1); *Richardson v. Commissioner*, 693 F.2d 1189 (5th Cir. 1982)).

Allocation Techniques

There are *two* permissible methods for allocating these items:

(i) The partnership can "close the books" just before the change in interests; *or*

Note: Items occurring before the closure would be reflected according to the old allocation; items occurring after the closure would be reflected according to the new allocation.

(ii) The item can simply be allocated on a daily basis.

Admission of a New Partner

- When there is a change in partnership interests during the year (as by admission of a new partner), the various items of income and deduction must be allocated between the partners for the periods before and after the change takes place (§706(c)(2)(B)).
- Such allocations must be done based on time.
  - Two permitted methods:
    - Close books before event
    - Daily allocation of items
- Retroactive allocations to new partners are forbidden (§706(d)(1)

Example

Engulf & Devour is a calendar year stock brokerage partnership in which E and D each have a fifty percent interest. On December 1, C is admitted, given a one-third share, and the firm is renamed Engulf, Devour & Consume. On July 1, the firm had an ordinary loss of $36,000. Engulf, Devour & Consume is not permitted to allocate this loss entirely to C. Instead, the partnership has two choices:

It can "close the books" on December 1. Then, the loss would be entirely allocated to E and D, because it occurred before the "books closed."

Alternatively, the loss can be allocated on a daily basis. Then, C would be entitled to deduct $1,000 of the loss. This figure is one-third of one-twelfth of the loss (one-twelfth because he was a partner only for one-twelfth of the year, one-third because he is a one-third partner).

Daily Allocation Required for Cash Items

For certain "cash basis items" (of cash basis partnerships), the Code *requires* allocation on a daily basis. The "closing the books" method is *not* allowed. These items include interest, taxes, payments for service, payments for the use of property, or other items to be added by regulation (§706(d)(2)).

Example

Using the previous example, assume that Engulf, Devour & Consume is a cash basis real estate partnership that paid interest of $18,000 on December 15 on a loan that was outstanding the entire year. If it could use the "closing the books" method, C would be entitled to one-third of the interest deduction since payment occurred after C became a partner. Under §706(d)(2), however, this is a cash basis item and must be allocated on a daily basis. Therefore, C could deduct only about $250 (one-third of one-twenty-fourth of the item).

Review Questions

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benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

49. Under §708(b)(1)(A), a partnership terminates when:

    a. The financial operations are no longer conducted by any of the partners.

    b. One partner of a two-partner firm dies.

    c. The partnership deliberately fails to file tax returns and make payments.

    d. The partnership sells its assets and is in the process of winding up the business.

50. What is the effect of a death of a partner?

    a. The deceased partner's distributive share of income for the year of death is reported on that partner's final tax return.

    b. The partner's estate reports the distributive share of income for the year of death.

    c. The year closes for the partnership.

    d. The partnership year closes only for the partner as of the date of death.

51. Which of the following is an allowable method to allocate income and deduction items among partners when a new partner is admitted during the year?

    a. close the books.

    b. monthly allocation.

    c. retroactive allocation.

    d. quarterly allocation.

Transactions Between Partner and Partnership

Treating Partner as Stranger - §707(a)

If a partner engages in a transaction with the partnership *other* than in his or her capacity as a partner, the transaction shall be considered as occurring between the partnership and a stranger (§707(a)).

Example

If a partner loans money to the partnership, the interest on the loan will be taxed as interest income to him and an interest deduction to the partnership. The interest deduction would decrease the partnership's income and thus decrease the partner's pro-rata share of that income (Pratt v. Commissioner, 550 F.2d 1023 (5th Cir. 1977)).

Such transactions include:

(1) *Non-Partner Transactions*- the performance of services for, or the transfer of property to, a partnership if there is a related direct or indirect allocation and distribution to a partner, and the entire transaction is properly characterized as occurring between the partnership and a partner *not acting in the capacity of a partner; and*

(2) *Sales & Exchanges*- the direct or indirect transfer of money or other property to a partnership if there is a related direct or indirect transfer of money or other property by the partnership to the contributing partner or another partner, and the transfers together are properly characterized as a *sale or exchange* of property.

Example

Where a partner was paid for advising the partnership, a service that he also rendered to many other clients, the partner was not acting in the capacity of a partner, and payments for the advice were treated as if made to outsiders. (Rev. Rul. 81-301, 1981-2 C.B. 144)

However, a partner who manages the partnership is acting in his capacity as a partner. Therefore, payments for such services are treated as distributive shares of partnership income or as guaranteed payments under §707(c). (Pratt v. Commissioner, supra)

Payments by Accrual Basis Partnership to Cash Basis Partner

When a partnership incurs any deductible expense, other than a guaranteed payment, from any person owning, directly or indirectly, a capital or profits interest in the partnership, it may *not* deduct the expense *until* the expense is paid and included in the person's gross income. This rule does not apply to certain qualified expenses of partnerships owning low-income housing.

Payments by Accrual Basis Partnership to Cash Basis Partner

- **When a partnership incurs any deductible expense, other than a guaranteed payment, from any person owning, directly or indirectly, a capital or profits interest in the partnership, it may not deduct the expense until the expense is paid and included in the person's gross income.**
- **This rule does not apply to certain qualified expenses of partnerships owning low-income housing.**

Guaranteed Payments - §707(c)

A partner can agree to work for a salary that is determined *without* reference to the partnership's income (§707(c)). Such a salary (called a "guaranteed payment") would be *income* to the recipient and often *deductible* (see below) to the partnership[8].

A partnership treats guaranteed payments to a partner for services, or for the use of capital as if they were made to a person who is *not* a partner. This is only to the extent the payments are figured *without* regard to the partnership's income. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are *not* subject to tax withholding as are payments to partnership employees (Reg. §1.707-1(c), R.R. 56-326).

> Note: A "guaranteed payment" is one determined "without regard to the income of the partnership." The word "income" in this sentence means *net income*, not gross income. Thus, a payment to a partner for managerial services, based on a percentage of the *gross income* of the partnership, is a guaranteed payment because it is determined "without regard to the income of the partnership" (R.R. 81-300).

Generally, the payments are *deductible* by the partnership as a *business* expense. They are included in Schedules K and K-1 of the partnership return and are reported by the individual partner on Form 1040 as ordinary income, in addition to his or her distributive share of the other ordinary income from the partnership.

Example

Under the partnership agreement, Dan is entitled to a fixed annual salary of $10,000 without regard to the income of the partnership. Dan's distributive share of the partnership income is 10%. The partnership has $60,000 of ordinary income after deducting the guaranteed payment. Dan must include ordinary income of $16,000 in his income tax return for his tax year in which the partnership tax year ends ($10,000 guaranteed payment plus $6,000 ($60,000 x 10%)).

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[8] Receipt of a guaranteed payment does *not* change the recipient partner's outside basis. Also, guaranteed payments are not subject to tax withholding as payments to partnership employees are.

Capitalization

A guaranteed payment is not *automatically* deductible. Often it must be capitalized (*Cagle v. Commissioner*, 63 T.C. 86 (1974), aff'd, 539 F.2d 409 (5th Cir. 1976)).

Prepaid & Capital Expenses - §707(c)

Section 707(c) explicitly refers to §263 which requires capitalization of expenditures with useful lives in excess of one year. In addition, payments described in §707(a) are also nondeductible if they must be capitalized (See *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980) - prepayment extending beyond the end of the taxable year, but covering less than twelve months, need not be capitalized).

Organization & Syndication Expenses - §709

Guaranteed payments made to a partner or partners for *organizing* the partnership or *syndicating* interests in the partnership are capital expenditures and are *not* deductible by the partnership. Section 709 requires capitalization of such amounts paid to organize a partnership (these *can* be amortized and deducted over a period of 180 months) or to promote the sale of partnership interests (these *cannot* be amortized). However, the payments must be included in the partner's tax return.

Guaranteed Minimum

If a partner is to receive a stipulated *minimum* payment from the partnership, the guaranteed payment is the amount by which the minimum payment is *more* than the partner's share of the partnership income *before* considering the minimum payment.

Example

Under the partnership agreement, Dan is to receive 40% of the partnership income, but in no event less than $8,000. The partnership has a net income of $15,000. Dan's share, without regard to the minimum guarantee, is $6,000 (40% of $15,000). Thus, the amount of the guaranteed payment that may be deducted by the partnership is $2,000 ($8,000 less $6,000). Dan's income from the partnership is $8,000, and the remaining $7,000 will be reported by the other partners in proportion to their shares under the partnership agreement. If the partnership net income had been $30,000, there would have been no guaranteed payment since his share, without regard to the guarantee, would have been greater than the guarantee.

Guaranteed Payments

- **A partner can agree to work for a salary that is determined <u>without</u> reference to the partnership's income (§707(c)).**
- **Such a guaranteed payment is <u>income</u> to the recipient and are <u>deductible</u> by the partnership as a business expense**
  - **However, guaranteed payments made to a partner for organizing the partnership or syndicating interests in the partnership are capital expenditures and are not deductible by the partnership**
- **Guaranteed payments are not subject to tax withholding as are payments to partnership employees (Reg. §1.707-1(c), R.R. 56-326).**

Year Taxed - §706(a)

A partner must include the guaranteed payments in income in the partner's tax year in which the partnership's tax year *ends*. Thus, a guaranteed payment is taxed to the recipient as of the close of the partnership's taxable year *regardless* of when it is *received* by the partner (§706(a)). However, a *cash basis* partner must include the guaranteed payment in income in the year the partnership *accrued* the expense, even if it was *not* paid in that year (Reg. §1.707-1(c)).

Example

Dan is a calendar year partner. The partnership's fiscal year ends on January 31, 2025. Dan received guaranteed payments from February 1, 2024, until December 31, 2024. Dan must include the guaranteed payments in his income for 2025 and report them on his 2025 income tax return.

Salary vs. Distribution

Thus, the treatment of *salaries* received by partners under §707(a) or 707(c) is different from other cash *distributions* to partners, which are *not* generally taxed to the partners but only reduce their outside basis. Whether a particular cash distribution is a nontaxable withdrawal of partnership cash depends upon an interpretation of the partnership agreement and a careful analysis of all circumstances (§707(a)(2)(A); *Falconer v. Commissioner*, supra).

Stranger Payment vs. Guaranteed Payment

The treatment of guaranteed payments under §707(c) is different from payments generated under §707(a) when the partner is treated as a stranger. Payments under §707(a) are taxed to the recipient under *his or her* method of accounting. Thus, an interest payment would be taxed to a cash basis recipient when *received* - not at the end of the partnership's year or when the partnership accrues a deduction (*Pratt v. Commissioner, supra).*

Payments Resulting in Loss

Assume that a partnership agreement provides guaranteed payments to a partner. The payments during the year resulted in a partnership loss which the partner shared. That partner must report the *full* amount of the guaranteed payments and must separately count the appropriate distributive *share* of the partnership loss.

Recipient of Salary as an "Employee"

The IRS has ruled that guaranteed payments are *not* treated as salary under other provisions of the Code. Partners are *not* considered employees of the partnership for tax purposes (R.R. 56-326; Reg. §1.707-1(c)).

Exception

Although the IRS takes the view that a partner can never be an employee of the partnership, except for the very limited purposes of §707(c), there is authority to the contrary. It has been held that a partner could be treated as an employee for the purposes of receiving tax-free meals and lodging for the convenience of the employer under §119 (*Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968)).

Accident & Health Insurance Premiums

Premiums for health insurance paid by a partnership on behalf of a partner for services rendered as a partner are treated as guaranteed payments. As such, they are deductible as business expenses by the partnership and are includible in the partner's gross income (R.R. 91-26). Partners may be able to deduct 100% of the amount paid for medical insurance as an adjustment to income if they meet certain requirements.

Certain Losses Disallowed - §707(b)

Ordinarily, when a partner sells property to the partnership (or the partnership sells property to a partner), it will be treated as a sale between strangers - i.e., gain or loss would ordinarily be *recognized* (§707(a)). However, a *loss* on such a sale is *not* deductible if the partner owns, directly or indirectly, *more than fifty percent* of the interest in capital or profits of the partnership (§707(b)(1)(A)).

Two Partnerships

If the sale or exchange is between *two* partnerships in which the *same* persons own, directly or indirectly, more than a 50% interest of the capital or profits in each, *no* loss deduction is allowed. However, if one of the purchasers later sells the property, any gain realized will be taxable *only* to the extent that it is *more* than the loss that was not allowed (§707(b)(1)(B)).

Constructive Ownership

For disallowance of losses (and certain sales at a gain discussed below), various rules of constructive ownership are provided so that if close relatives of the seller or buyer are partners, the loss would still be disallowed (§707(b)(3) & §267(c)).

Disallowed Losses

- **Ordinarily when a partner sells property to the partnership (or the partnership sells property to a partner), it will be treated like a sale between strangers - i.e., gain or loss would ordinarily be recognized (§707(a)).**
- **However, a loss on such sale is not deductible if the partner owns, directly or indirectly, more than a 50% interest in the partnership (§707(b)(1)(A)).**
- **In addition, if a sale or exchange is between two partnerships in which the same persons own, directly or indirectly, more than a 50% interest of the capital or profits in each, no loss deduction is allowed**

Determination of the 50% ownership in partnership capital or profits is made by applying the following rules:

(1) An interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual is considered as owning the interest owned, directly or indirectly, by or for the individual's family[9]; *and*

(3) An interest constructively owned by a person under rule (1) is treated, for applying rules (1) or (2), as actually owned by that person.

> Note: However, an interest constructively owned by an individual under rule (2) is not again treated as owned by that person for applying rule (2) to make another the constructive owner of the interest.

Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is *not* an actual partner, but only for establishing that another partner may be considered the constructive owner of the partnership interest.

Sales at Gain

When assets are sold by a partner to a partnership (or a partnership to a partner) at a *gain* and the partner owns, directly or indirectly, *more than fifty percent* of the capital or profits of the partnership, the gain is *ordinary income* rather than capital gain. This rule applies *only* if the asset is *not* a capital asset in the hands of the transferor. Property that is not a capital asset includes but is not limited to, trade accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

Similarly, a capital gain on a sale between *two* partnerships with *fifty percent common* ownership is treated as ordinary income (§707(b)(2)).

Review Questions

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[9] The family of an individual includes only brothers and sisters (including half-brothers and half-sisters), spouse, ancestors, and lineal descendants.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

52. Under §707(c), what is a characteristic of guaranteed payments?
   a. They are not deductible by the partnership.
   b. They are calculated independently of the partnership's income.
   c. They are subject to tax withholding.
   d. They change the recipient partner's outside basis.

53. How are guaranteed payments issued to a partner for syndicating partnership interests treated?
   a. They are capital expenditures.
   b. They are deductible by the partnership as a business expense.
   c. They can be excluded from the partner's tax return.
   d. They may be amortized over a period of sixty months.

54. Generally, a partner is not treated as an employee. However, under §119, when can a partner be viewed as an employee?
   a. for purposes of receiving healthcare benefits.
   b. for purposes of receiving tax-free meals and lodging for the employer's convenience.
   c. for employment tax purposes.
   d. when the partner receives guaranteed payments.

55. When a partnership pays a partner's health insurance premiums for services performed, the amounts:
   a. are excluded from the partner's gross income.
   b. are nondeductible by the partnership.
   c. may be amortized by the partnership.
   d. may be 100% deductible by the partner.

56. Under §707(b) when is a loss on sale of property deductible?
   a. A majority partner sells property to the partnership.
   b. A minority interest partner sells property to the partnership.
   c. A sale between two partnerships where the same partners hold majority interests in each partnership.
   d. A sale where close relatives of the seller or buyer are partners.

Learning Objectives

After reading Chapter 3, participants will be able to:

1. Recognize the tax-free capitalization rules of §721 by:
   a. Specifying the differences between a contribution and a sale or exchange recognizing the treatment of transfers to investment company type partnerships; and
   b. Identifying when the property taint rules apply and methods of allocation for precontribution gain or loss.
2. Determine a partnership's basis for contributed assets under §723.
3. Specify the taxation of contributed services and strategies to avoid immediate taxation.
4. Determine the original and adjusted basis of an interest acquired by contributing property and/or money under §722.
5. Recognize a partner's loss deduction when the limits on deductions of partnership losses apply by:
   a. Determining amounts at risk under §465; and
   b. Specifying the buckets of income under §469 identifying the impact of passive loss rules.

CHAPTER 3

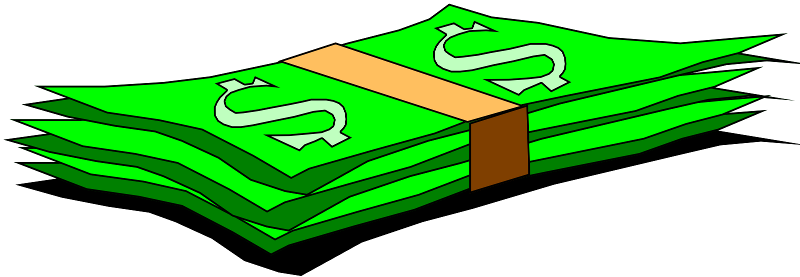
Contributions to Partnerships

Contributions of Property - §721

No gain or loss is recognized to the partnership *or* the partners upon a contribution of property to the partnership in exchange for a partnership interest (§721). This nonrecognition provision is based on the idea that the formation of a partnership is not an appropriate time to tax the partner on gain or loss on the assets contributed to the partnership. This rule applies to a partnership in the process of formation *and* to one that is already operating.

Note: Section 721 does not deal directly with the effect of receiving cash (or other) "boot" when making transfers to a partnership. This is handled under the provisions dealing with distributions (§733, §731, §752). Under §733, a cash distribution decreases a partner's outside basis. However, the distribution is not taxable unless it is in excess of the partner's outside basis immediately before the transfer. Under §752, the transfer of encumbered property is treated as a cash distribution to the extent of the debt assumed or taken subject to by the partnership.

Contributions of Property to Partnership



- **No gain or loss is recognized to the partnership or the partners upon a contribution of property to the partnership in exchange for a partnership interest (§721)**
- **Section 721 does not deal directly with the effect of receiving cash (or other) "boot" when making transfers to a partnership.**
  - **This is handled under the rules dealing with distributions (§733, §731, §752)**
  - **For example, the transfer of encumbered property is treated as a cash distribution to the extent of the debt (§752)**
  - **However, a distribution is not taxable unless it is in excess of the partner's outside basis**

Contribution vs. Sale or Exchange

The partner could sell the asset to the partnership instead of contributing it. Then, he or she would recognize gain or loss on the transfer. Note that loss deductions are disallowed if the partner directly or indirectly owns *more than fifty percent* of the partnership and gain is sometimes ordinary.

Disguised Sale - §707(a)

The Code provides that a sale that is disguised as a contribution (followed by an allocation or distribution to the partner which in substance is payment for the property) must be treated as a *sale*, not a contribution (§707(a)(2)(B)). The IRS recently issued final regulations identifying transactions structured as partnership contributions and distributions that are in fact sales or exchanges (Reg. §1.707-0 and §1.707-2 through §1.707-9). These regulations presume that contributions and distributions made *within* a two-year period are *sales*.

Disguised Taxable Exchanges - §704 & §737

A transaction *may* be treated as an *exchange* of property between partners on which gain or loss is recognized *if* a partner contributes property to a partnership and within a short period:

(1) Before or after the contribution, *other* property is distributed to the *contributing* partner and the contributed property is kept by the partnership; *or*

(2) After the contribution, the *contributed* property is distributed to *another* partner.

Precontribution Gain or Loss Property

When property with a fair market value above basis (precontribution gain) or below basis (precontribution loss) is contributed to a partnership, the precontribution gain or loss must be allocated to the contributing partner in any later disposition of the property by the partnership (§704(c), Reg. §1.704-3)). This "taint" to the contributing partner applies not only to *sales* but also to *distributions* made by the partnership.

> Note: As a result of this rule, it would be a good idea to have an appraisal of such property at the time of the contribution. The contribution and later sale or disposition could be separated by many years. Failure to obtain initial market information could open a needless dispute with the Service as to the amount of the precontribution gain or loss.

Pre-Contribution Gain or Loss Allocation Triggers

- **Contribution of property followed its sale at anytime - §704(c)**
  - **Three reasonable methods:**
    - **Traditional**
    - **Traditional with curative allocations**
    - **Remedial allocation**
- **Contribution of property followed by distribution of another property to the contributor - §737**
- **Contribution of property followed by distribution of that property to another partner - §704(c)(1)(B)**

Property Distribution to Contributing Partner - §737

When property (other than the contributed property) is distributed to a partner who contributed *built-in gain property*, gain is recognized to the extent of the *lesser* of:

(1) The excess (if any) of:

(a) The fair market value of any property (other than money) received, over

(b) The adjusted basis of the partner's interest in the partnership immediately before the distribution reduced (but not below zero) by any money received in the distribution, *or*

(2) The *net precontribution gain* of the partner.

> Note: Net precontribution gain means the net gain (if any) that the partner would have recognized if all the partnership property that had been contributed by the partner *within 7 years* (formerly 5 years) of the distribution had been distributed by the partnership to another partner (§737(b)).

This rule applies to distributions made *after June 24, 1992*. The Service has issued proposed regulations providing rules for determining when §737 applies and the amount of gain or loss that must be recognized by the contributing partner under §737 (Prop Reg. §1.737-1).

Example

Dan and Ralph form a partnership, with Dan contributing property X and Ralph contributing property Y to the partnership. Y is distributed to Dan within five years of the contributions, at a time when there were no intervening distributions or dispositions of partnership property. Dan recognizes any built-in gain on X to the extent the value of Y exceeds the basis of his partnership interest.

The character of the gain is determined by reference to the proportionate character of the net precontribution gain (§737(a)). This gain is in *addition* to any gain the partner must recognize if the amount of money distributed is more than his or her basis in the partnership under §731.

Where *a partner makes multiple contributions*, built-in losses are netted against built-in gains.

> Note: To the extent that contributed property is distributed back to the partner that contributed it, that partner doesn't have to recognize gain or loss (§704(c)(1)(B)).

Anti-Abuse Rules Under §737

The proposed regulations under §737 include anti-abuse rules that provide that the provisions of §737 must be applied in a manner consistent with the purpose of §737 (Prop. Reg. §1.737-4). Under these regulations, if a principal purpose of a transaction is inconsistent with §737, the IRS can *recast* the transaction to be consistent with the purpose of §737. The proposed regulations would apply to distributions made *after January 8, 1995*.

Contributed Property Distribution to Another Partner - §704(c)

When property with a basis *different* than its fair market value is contributed to a partnership, *and* within seven (formerly five) years, is distributed to a partner *other* than the contributing partner, the distribution is treated like a sale by the *contributing* partner (§704(c)(1)(B)). This provision covers both direct and *indirect* distributions made *after June 24, 1992*.

> Note: The Service has issued proposed regulations to determine when §704(c)(1)(B) applies and the amount of gain or loss that must be recognized (Prop. Reg. §1.704-4).

Thus, where a partner contributes property with a basis *different* from its fair market value to a partnership and *within seven years* of the contribution, the partnership distributes the property to *another* partner, the following occurs:

(1) The distributed property is treated as *sold* by the partnership for its fair market value and the *contributing* partner recognizes gain or loss equal to that which would have been allocated to him or her under §704(c); *and*

(2) The adjusted basis of the contributing partner's interest in the partnership and the adjusted basis of the distributed property, are *adjusted* to reflect the gain or loss recognized (§704(c)(1)(B)).

Example

Dan contributes property to a partnership at a time when its basis is $20,000 and its value is $100,000. Two years later, when the property is worth $150,000, the partnership distributes it to Ralph. Dan is treated as recognizing gain in the amount of $80,000.

However, if like-kind property is distributed to a partner after property contributed by that partner is distributed to another partner, within the time limit, then the contributing partner does *not* recognize gain or loss to the extent of the like-kind property's value (§704(c)(2)).

Seven-Year Period (Formerly Five)

The TRA '97 extended from 5 years to 7 years the period in which a partner recognizes pre-contribution gain with respect to property contributed to a partnership.

Note: This provision is effective for property contributed to a partnership after June 8, 1997. An exception is provided for property contributed to a partnership pursuant to a written binding contract in effect on June 8, 1997.

Allocation Methods for Precontribution Gain or Loss

A partnership must allocate income, gains, losses, and deductions for property contributed by a partner in order to account for any difference between the property's basis and its fair market value at the time of contribution. The partnership can use any reasonable method to make such allocations. However, Reg. §1.704-3 provides three acceptable methods of allocation:

(1) Traditional method,

Note: Under this method, upon the disposition of the property, the partnership must allocate to the contributing partner the precontribution gain or loss first, and then any excess is allocated pursuant to the partnership agreement. The partnership must allocate cost recovery deductions for the property to reduce the precontribution gain or loss.

(2) Traditional method with curative allocations to offset the ceiling rule[1], *and*

Note: This method is used to overcome distortions made by application of the ceiling rule. When a noncontributing partner is allocated less depreciation than book depreciation, the partnership can make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference. The curative allocation must be reasonable and cannot exceed the amount required to offset the effect of the ceiling rule.

(3) Remedial method to correct for differences between book and tax items.

Note: Under this method, the partnership first determines the amount of book items attributable to the contributed property and then determines the distributive share. If the distributive share is limited by the ceiling rule, a remedial allocation is made to the noncontributing partner and an offsetting allocation is made to the contributing partner. However, the tax attributes of the offsetting remedial allocations must have the same effect on each partner's tax liability as the item is limited by the ceiling rule. Remedial allocations do not affect the partner's capital account or the partnership's income or property basis.

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[1] The ceiling rule requires that the total income, gains, losses, deductions, or credits allocated to the partners for a property cannot exceed the total partnership income, gains, losses, deductions, or credits on that property.

Transfers to Investment Company Type Partnerships - §721(b)

Gain (but not loss) *is* recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company *if* the partnership were incorporated. This requires the current taxation of gains realized by investors who transfer appreciated stock, securities, or other property to an exchange fund operated as a partnership. A loss realized on a contribution of stock, securities, or other property to a partnership is *not* recognized.

A partnership is treated as an investment company if, after the exchange, over 80% of the value of its assets, excluding cash and nonconvertible debt obligations, is held for investment and consists of readily marketable stocks, securities, or interests in regulated investment companies or real estate. An investment company under this test is ordinarily determined immediately after the transfers of property under the same plan or as part of the same transaction.

In addition, for the nonrecognition treatment to be denied, the transfers of property to the partnership must result, directly or indirectly, in *diversification* of the transferors' interests. These rules apply to both limited partnerships and general partnerships, regardless of whether the partnership is privately formed or publicly syndicated.

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57. Under §721, how is a contribution of property for a partnership interest treated?

   a. The partnership would recognize gain or loss on the transfer.

   b. There is no gain or loss to the partnership or the partners.

   c. The partner would recognize gain or loss on the transfer.

d. The precontribution gain or loss must be allocated to the contributing partner at the time of contribution.

58. Under §704(c)(2) if, within the required time, a partner contributes property to a partnership that is distributed to another partner and then subsequently receives like-kind property:

a. the adjusted basis of the contributing partner's partnership interest and of the distributed property are adjusted to reflect the gain or loss recognized.

b. no gain or loss is recognized to the extent of the like-kind property's value by the contributing partner.

c. the contributing partner recognizes gain or loss equal to that which would have been allocated to him or her.

d. the distributed property is treated as sold by the partnership for its fair market value.

59. Which of the following is an approved basis for allocation of a precontribution gain under Reg. §1.704-3?

a. Distributive.

b. Traditional.

c. Guaranteed.

d. Restrictive.

Contributed Assets Inside (Partnership) Basis - §723

The partnership's basis of property contributed to it by a partner is the *same* as the adjusted basis of such property to the contributing partner (§723). If the contributed property is *nonbusiness* property, the partnership's basis is the *lesser* of the partner's adjusted basis *or* the fair market value on the date contributed. The partnership's basis for its assets is often called "inside basis."

> Note: Another option would be for the partner to sell the property to the partnership, rather than contribute it, in which case the partner would be treated under §707(a) as an unrelated party. The partnership's inside basis would then be equal to its purchase price.

Thus, when the partnership sells the property, the previously unrecognized gain or loss would be recognized and *divided* among the partners (according to the allocation explained below).

Inside vs. Outside Basis in a Partnership

- **Outside basis refers to a partner's basis for the partnership interest. This figure would be used to compute gain or loss on disposition of the interest.**
- **Inside basis refers to the basis of assets held by the partnership. This figure would be used to compute gain or loss on disposition of a particular partnership asset.**

Allocations as to Contributed Property - §704(c)

The *fair market value* of property at the time a partner contributes it may be *different* from its *adjusted basis* in his or her hands. Absent rules to prevent it, the contribution (and later sale or distribution) of property with a basis different than its fair market value could result in the abusive shifting of income, gain, and loss. The purpose of §704(c) is to prevent the *shifting* of tax consequences among partners on *precontribution* gain or loss.

For contributed property, the partnership *must* allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for all or any part of this difference between value and basis (§704(c)). Thus, only *later* appreciation or depreciation is allocated among the partners according to their agreement.

> Note: The Service has issued proposed regulations providing guidance on how to make such allocations (Prop. Reg. §1.704-3). The regulations state that any reasonable method is acceptable and suggest three sample methods.

Example

Dan contributes a liquor store down at the beach to the Free Spirit partnership when its basis is $40,000 but its value is $120,000. While Free Spirit holds the store, it further appreciates to $150,000 and it is sold to Raoul for $150,000. Free Spirit's inside basis for the store is $40,000. However, its gain of $110,000 is not divided equally among all partners. The $80,000 unrecognized gain at the time of contribution must be allocated to Dan; the balance of the gain ($30,000) is divided among all partners (including Dan) in accordance with the profit-sharing ratio of their partnership agreement.

Liabilities

Similar principles govern the *assumption of liabilities* by the partnership from cash basis partners (who have incurred but not yet deducted the item). When the partnership pays the debt, the *entire* deduction will be allocated to the *contributing* partner (§704(c)).

Earlier Optional Application of §704(c)

This same allocation applies to depreciation, depletion, gain, or loss on property contributed to the partnership *before April 1, 1984*, if the partnership agreement so provides. However, the amount allocated to a partner in this manner may not be more than the total of the amount allowable to the partnership for tax purposes. The allocation may apply to all property contributed, or only to specific items.

Character of Subsequent Gain

If a contributed property was an *unrealized receivable* or was an *inventory* item to the contributing partners, *any* gain, or loss upon *disposition* of such asset by the partnership is *ordinary* rather than capital.

> Note: Under §751(c), unrealized receivables are rights to payment, not previously includable in income, for past or future sales of goods or services. Inventory items are any assets that would not be capital assets or property described in §1231.

Taint On Contribution - §724

The taint on inventory items lasts only *five years* after they are contributed to the partnership, but the taint on unrealized receivables lasts *indefinitely* (§724).

Example

El Camino Del Rey Vista Estates was property held for sale to spendthrift yuppies by partner Dan in the ordinary course of his business (See §§1221(1) & 1231(b)(1)(B)). However, once contributed to the XYZ partnership, it became a capital asset (or a §1231 asset). Three years later, XYZ sells El Camino Del Rey Vista Estates at a gain. The gain is ordinary income. Note also that any portion of the gain that relates back to the time before the property was contributed to XYZ must be allocated to Dan (§704(c)).

Character of Subsequent Loss - §724(c)

If contributed property is a *capital asset* in the hands of the contributing partner, any loss recognized on the disposition of the property for the next *five years* will be a *capital loss* to the extent of the "built-in loss" on the asset at the time it was contributed (§724(c)).

Example

In 2022 Dan contributed a squirrel ranch that was a capital asset in his hands to the Fantasy Fur partnership. While only worth $40,000, its basis to Dan was $100,000. The asset was not a capital asset in the hands of Fantasy Fur because it is a dealer in such ranches and held the property for sale in the ordinary course of business under (§1221(1)). Fantasy Fur sells the land for $25,000 in 2024. The partnership has a $75,000 loss of which $60,000 is a capital loss and only $15,000 is an ordinary loss. Moreover, the $60,000 capital loss must be allocated to Dan (§704(c)).

Character of Subsequent Gain & Loss

- **If contributed property was an unrealized receivable or was an inventory item to the contributing partners, any gain or loss upon disposition of such asset by the partnership is ordinary rather than capital.**
- **The taint on inventory items lasts only 5 years after they are contributed to the partnership, but the taint on unrealized receivables lasts indefinitely (§724).**
- **If contributed property is a capital asset in the hands of the contributing partner, any loss recognized on the disposition of the property for the next 5 years will be a capital loss to the extent of the built-in loss on the date of contribution (§724(c))**

Contribution of Services

A partner may acquire an interest in partnership capital as *compensation* in whole or in part for services performed or to be performed. When a partner promises to render services, and in exchange receives an interest in the *capital* of the partnership, he or she is immediately taxed[2] on the value of that interest since the interest is considered property paid to the partner in exchange for rendering services (§83; Reg. §1.721-1(b)). The fair market value of any part of an interest in partnership capital transferred to a partner in payment for services rendered to the partnership constitutes a *guaranteed payment*. However, if a partner merely receives an interest in future *profits*, the partner may not be taxed until profits are received.

Note: A "capital interest" in a partnership entitles its owner to a pro-rata share of the partnership's assets if the partnership is dissolved. A "profits interest" entitles one only to a share of the profits but not to any part of the assets that other partners have contributed or earned.

Example

Dan, a senior associate of law partnership Trials & Tribulation, is made a ten percent partner on December 31. This entitles him to ten percent of the future profits or losses of Trials & Tribulation. However, if the partnership were dissolved later, Dan would receive nothing because he is not entitled to any part of the assets owned by the partnership. Dan has only a profits interest, not a capital interest.

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[2] The fair market value of such an interest generally must be included in the partner's gross income in the first tax year in which the partner's interest becomes transferable or not subject to a substantial risk of forfeiture.

In R.P. 93-27, the IRS held that the receipt of a *profit* interest for services is *not* a taxable event if the person receives that interest either as a partner or in anticipation of becoming one. The ruling does *not* apply, however, when:

(1) The profits interest relates to a substantially *certain* and *predictable* stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) The partner disposes of the profits interest *within two years* of its receipt; *or*

(3) The profits interest is a limited partnership interest in a *publicly traded partnership* under §7704.

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and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

60. Section 723 provides guidelines for the treatment of the basis of property that is contributed to a partnership. What is "inside basis"?

a. the partner's basis for the interest in the partnership.

b. the figure used to compute gain or loss on disposition of a partnership interest.

c. the partnership's basis for its assets.

d. the partnership's basis for nonbusiness property only.

61. A partner should consider the effects of contributing business assets versus selling business assets to a partnership. When a partner sells business property to the partnership, what does the partnership's inside basis equal?

a. the property's purchase price.

b. the property's assessed value.

c. the fair market value on the date contributed.

d. the partner's adjusted basis.

62. When a partnership assumes a loan that has not been deducted by a cash basis partner and subsequently pays the loan, the deduction would be allocated:

a. to the contributing partner.

b. among the partners pursuant to the partnership agreement.

c. equally among the partners.

d. to the general partners.

63. A partner may receive a capital interest or a profits interest in a partnership. When a partner receives a profits interest in a partnership:

a. the interest is a guaranteed payment.

b. the partner is entitled to a pro-rata share of the partnership's assets if the partnership is dissolved.

c. the partner is entitled only to a share of the profits.

d. the partner is immediately taxed.

64. Under R.P. 93-27, which of the following events where a partner receives a profit interest for services performed is nontaxable?

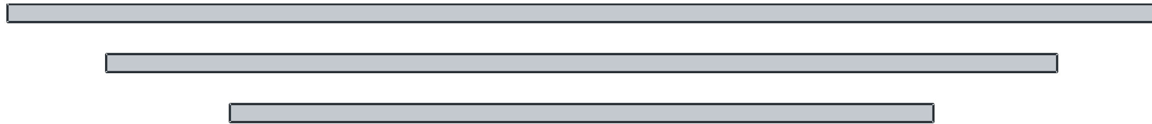
a. The interest is a limited partnership interest in a publicly traded partnership.

b. The interest is received by a person who is anticipating becoming a partner.

c. The interest is associated with a substantially certain and predictable

income flow from partnership assets.

d. The partner sells the interest within two years of its receipt.



Basis of Partner's Interest - Outside Basis

It is often necessary to determine the basis for a partner's interest in the partnership (his or her "outside basis"). In general, when a partner contributes property to a partnership, his or her outside basis is *equal* to the adjusted basis of the contributed asset (§722).

The determination of the adjusted basis of a partner's partnership interest is ordinarily made at the *end* of a partnership's tax year. However, if there has been a sale or exchange of all or a part of the partner's interest or a liquidation of his or her entire interest in a partnership, the adjusted basis of the interest must be determined on the date of the sale, exchange, or liquidation. A partner's adjusted basis for an interest in a partnership can *never* be less than *zero*.

The adjusted basis of a partner's interest is determined *without* regard to any amount shown in the partnership books as a capital, equity, or similar account.

Example

Dan contributes to a partnership property that has an adjusted basis of $400 and a fair market value of $1,000. His partner contributes $1,000 cash. While under the partnership agreement each has a capital account in the partnership of $1,000, which will be reflected in the partnership books, the adjusted basis of Dan's interest is only $400 and his partner's basis is $1,000.

Original Basis - §722

The original basis of an interest acquired by contributing property and money is the money a partner contributed plus the adjusted basis of the property he or she contributed. If the acquisition of an interest in a partnership results in *taxable* in-

come to the partner, the income will generally be *included* in the basis of his or her interest.

Adjustments to Basis

The original basis of an interest will be *increased* by:

(1) Further contributions to the partnership,

(2) The partner's distributive share of both taxable and nontaxable partnership income,

(3) The excess of the deductions for depletion over the basis of the depletable property, and

(4) His or her share of an investment credit recapture adjustment to any partnership property basis that was reduced when the credit was taken.

A partner's basis will be *decreased* (but never below *zero*) by:

(1) The amount of money and the adjusted basis of property distributed to the partner by the partnership,

(2) His or her distributive share of the partnership losses (including capital losses),

(3) Nondeductible partnership expenses that are not capital expenditures,

(4) The amount of any deduction for depletion with respect to oil and gas wells, *and*

(5) The partner's share of any partnership property basis reduction that is required if the property qualifies for the investment credit.

If a partner receives distributions of money or other property in a year in which there is a partnership loss, he or she must take the distribution into account *before* computing the amount of the partnership loss that can be deducted.

Effect of Liabilities - §752

Changes in partnership liabilities[3] affect a partner's outside basis *as if* cash were contributed *or* distributed by the partnership. Thus an increase in partnership liabilities *increases* a partner's outside basis - as if he or she had *contributed* cash to the partnership (§752(a)).

A decrease in partnership liabilities *decreases* outside basis - as if the partnership had *distributed* cash to him or her (§752(b). Similarly, if a partnership takes over a partner's liability, this *decreases* his or her outside basis (§752(b)).

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[3] The term liabilities includes the partnership's obligations for the payment of outstanding trade accounts, notes, and accrued expenses whether or not they are recorded on the partnership books under its method of accounting.

Effect of Liabilities

- **Changes in partnership liabilities affect a partner's outside basis as if cash were contributed or distributed by the partnership**
- **An increase in partnership liabilities <u>increases</u> a partner's outside basis - as if they had <u>contributed cash</u> to the partnership (§752(a))**
- **A decrease in partnership liabilities <u>decreases</u> outside basis - as if the partnership had <u>distributed cash</u> to him (§752(b))**
- **Accrued but unpaid liabilities of cash basis partnerships are not treated as liabilities for §752**

Example

Beauregard contributes Terra to Stars & Bars, an equal partnership made up of Beauregard and Scarlet. The basis of Terra in Beauregard's hands is $120,000; its value is $200,000. Terra is subject to a $30,000 liability owed to dirty rotten Yankee carpet baggers. Beauregard's outside basis is increased $105,000; $120,000 (the basis of Terra), decreased by $30,000 (partnership took over his liability) and increased by $15,000 (Beauregard's share of the increase in liabilities). Scarlet's outside basis has also increased $15,000 (her share of the increase in liabilities). If Stars & Bars pays off the liability, Beauregard and Scarlet would each decrease their outside basis $15,000.

Deemed Distribution & Contribution

A decrease in a partner's share of liabilities, or an assumption by a partnership of a partner's personal liability, is treated as a *distribution of money*. If the "distribution" *exceeds* a partner's outside basis, *gain* is recognized. (§731(a)(1)).

If property is contributed *subject to* indebtedness *or* if a partner's liabilities are *assumed* by the partnership, the basis of that partner's interest is *reduced* by the liability assumed by the other partners. This partner must reduce his or her basis because the assumption of the liability is treated as a *distribution* of money to that partner. The *other* partners' assumption of the liability is treated as though they *contributed* money to the partnership.

Example

John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of $8,000 and a $4,000 mortgage. The partnership assumed payment of the mortgage. The adjusted basis of John's interest is the adjusted basis of contributed property ($8,000), less the part of the mortgage assumed by other partners and treated as a distribution ($3,200, i.e., 80% of $4,000) or $4,800.

Example

If, in the above example, the property John contributed had a $12,000 mortgage, the adjusted basis of his partnership interest would be zero. The difference between the amount of the mortgage assumed by the other partners, $9,600 (80% x $12,000), and his basis of $8,000 would be treated as his

gain from the sale or exchange of a capital asset. However, this gain would not increase the basis of his partnership interest.

Special Rule for Liabilities of Cash Basis Partnership

Accrued but unpaid liabilities of cash basis partnerships are *not* treated as liabilities for §752 (H. Rept. 98-861, p. 856).

Example

Attorney Dan (who uses the cash method of accounting) contributes his solo law practice to the Robbing & Rooking partnership. The basis for the contributed assets is $3,000. Dan owes $7,000 in debts for pencils and white-out, which he has not paid. His outside basis is $3,000 and he does not have gain on the contribution.

Partner's Share of Partnership Liabilities

A partner's share of partnership liabilities will be determined in accordance with the partner's ratio for sharing *losses* under the partnership agreement. However, when *none* of the partners has any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership *without* the assumption by the partnership or any of the partners of any liability on the mortgage), then *all* partners will be considered as sharing this liability in the same ratio as they share the *profits*.

Limited partnerships

In a limited partnership, the limited partners are *not* liable for partnership debts in excess of their contribution, but the general partner has *unlimited* liability. Therefore, an increase in partnership liabilities increases the outside basis *only* of the *general* partner, *not* the *limited* partner.

Exception

If *none* of the partners has any personal liability on the debt (as in a "nonrecourse" mortgage), *both* general and limited partners *increase* their outside bases by the amount of such loan (Reg. §1.752-1(e); R.R. 77-309). However, the "at-risk" rules of §465 may deny the partners the benefit of the basis increase from the nonrecourse loan.

Partner's Share of Liabilities

- A partner"s share of partnership liabilities is determined in accordance with the partner's ratio for sharing <u>losses</u>.
- However, when <u>none</u> of the partners has any personal liability with respect to a partnership liability then all partners will be considered as sharing this liability in the same ratio as they share the <u>profits</u>.
- In a limited partnership, the limited partners are not liable for partnership debts in excess of their contribution, but the general partner has unlimited liability.
  - Therefore, an increase in partnership liabilities increases the outside basis <u>only</u> of the <u>general</u> partner, not the limited partner.

Guarantees

If a loan to the partnership is *nonrecourse*, but the general partner guarantees it, the loan is allocated *entirely* to the general partner, *not* to the limited partners (Deficit Reduction act of 1984, §79, requiring the Commissioner to amend the regulations under §752; R.R. 83-151).

Example

Lazlo and Raoul are equal partners in Deferred Maintenance a limited partnership that owns a combined low-income housing project and polo field. The partnership borrows $500,000 for which the partnership is liable. Lazlo (the general partner) increases his basis $500,000; Raoul does not increase his basis. If Deferred Maintenance were not liable to repay the $500,000, each partner would increase his basis $250,000.

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65. Four items will increase the original basis of a partner's interest. What is one of these items?

    a. partnership expenses that cannot be deducted and do not qualify as capital expenses.

    b. deductible amounts for depletion relating to oil and gas wells.

    c. the amount of money and the adjusted basis of property received by the partner from the partnership.

    d. the partner's share of an investment credit recapture adjustment to partnership property basis that was reduced at the time the credit was taken.

66. Under §731, the assumption of a partner's personal liability by a partnership is:

a. not treated as a liability.

b. treated as a guaranteed payment.

c. treated as a loan.

d. treated as a distribution of money.

67. A partnership may acquire a real estate mortgage without an assumption of liability by the partnership or any of the partners. What is the result of this transaction?

a. All partners share the liability in the same ratio as they share the profits.

b. The general and limited partners' outside bases decrease.

c. The general partner's outside basis decreases.

d. The share of the liability is determined according to the partner's ratio for sharing losses.

Limits on Deduction of Partnership Losses

At-Risk Rule - §465

A partner can deduct partnership losses only to the extent of his or her outside basis (§704(d)). However, a partner *also* is not permitted to deduct partnership losses beyond the amount they have placed "at-risk" in the partnership. Special at-risk rules apply to most activities, including activities of a partnership that are engaged in as a trade or business or for the production of income.

These rules limit the amount of loss a partner may deduct to the amounts for which that partner is considered *at risk* in the activity. Thus, a partner may *not* deduct losses of the partnership by reason of increases in their basis occurring because of partnership liabilities *for which they are not personally liable* (§465).

Example

Downtrend & Upshot is a 50/50 partnership (general or limited) that makes stock market investments in South American junk bonds. The partnership borrows $100,000 to buy bonds but has no liability to repay it (since all debts related to South American bonds are insured by U.S. taxpayers). Neither partner can use their share of the $100,000 debt to deduct partnership losses. However, they can add the debt to their outside basis for any purpose other than deducting losses, e.g., to avoid tax on a cash distribution.

At-Risk Limits - §465

The at-risk rules limit losses from certain activities to the lesser of:

(1) the loss, or

(2) the amount at-risk

A taxpayer is at-risk in any activity for:

(1) the money & basis of property contributed to the activity, and

(2) amounts borrowed for use in the activity if the taxpayer:

(a) is personally liable, or

(b) pledges property as security for the loan

Computation

When determining a partner's loss deduction, first, the general loss limitation rule is invoked (i.e., the deduction is limited to the partner's interest at the end of the partnership year before considering any losses). Then, the at-risk provisions are applied to see if the remaining loss is still deductible. Suspended losses are carried forward until a partner has a sufficient amount at risk in the activity to absorb them.

When the at-risk amount at the end of any tax year is less than zero, the excess amount must be included in the partner's gross *income* (i.e., losses for which deductions were previously allowed are recaptured). Negative amounts at risk can occur because of a distribution or conversion of recourse debt to nonrecourse debt.

Exception for Real Estate Loans

The at-risk rules apply to real estate investments in the same way they apply to all other investments. However, there is one important exception: *A taxpayer is treated as being at risk on nonrecourse loans provided by government entities.* In addition, a taxpayer is at risk for loans provided by qualified persons.

Qualified Persons

Qualified persons are actively and regularly engaged in lending money (e.g., banks or savings and loans). However, financing provided by the *seller* of the property to the taxpayer does *not* qualify under this exception *even if* the lender is a qualified person (§465(b)(6) & §46(c)(8)(D)(iv)).

Definition of Amounts At-Risk

A partner is considered at risk for:

(1) The amount of *money* and the *adjusted basis of any property* he or she contributed to the activity,

(2) The *income retained* by the partnership, *and*

(3) Certain amounts borrowed by the partnership for use in the activity.

However, a partner is generally *not* considered at risk for amounts borrowed *unless* that partner is *personally* liable for repayment, or the amounts borrowed are secured by the *partner's* property *other* than property used in the activity. A partner is *not* considered at risk for amounts *protected against loss* through guarantees, stop-loss agreements, or other similar arrangements. Nor is the partner at risk for amounts borrowed if the lender has an interest in the activity (other than as a creditor) or if the lender is related to a person (other than the partner) having such an interest.

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68. When calculating a partner's loss deduction:
    - a. negative amounts at risk are carried forward.
    - b. the at-risk provisions are applied second.
    - c. the deduction is limited to the partner's interest including any losses.
    - d. suspended losses are carried forward for two years.
69. An exception to the at-risk rules for investments in real estate considers a taxpayer at risk on a nonrecourse loan provided by a:
    - a. government entity.
    - b. partnership.
    - c. manufacturing company
    - d. charitable organization.
70. Which of the following meets the definition of a qualified person?
    - a. a dentist.
    - b. an accounting firm.
    - c. a law firm
    - d. a bank

71. For which of the following would a partner be at risk?
    a. amounts borrowed if the lender has an interest in the activity.
    b. amounts borrowed if the lender is related to a person having an interest in the activity.
    c. amounts borrowed that are secured by the partner's property other than property used in the activity.
    d. amounts borrowed for which the partner has no personal liability.
72. For which item would a partner be considered not at risk?
    a. amounts borrowed by the partnership for use in the activity if the partner is personally liable.
    b. amounts protected against loss through stop-loss agreements.
    c. the adjusted basis of any property contributed to the activity.
    d. the income retained by the partnership.

Passive Losses - §469

A partnership loss share also may be disallowed under the §469 passive activity provisions. Under 469, a partner *cannot* deduct losses from "passive activities" against other income (such as income from a profession or income from investments). These provisions curtail almost all "tax shelters."

Three Buckets

The provisions require taxpayers to separate their activities into three groups:

Material Participation

Earned income, such as salary and wages; income or loss from a trade or business in which the taxpayer materially participates on a regular, continuous, and substantial basis; and guaranteed payments from a partnership for *services* (but no guaranteed payments for interest on capital). Participation in an activity is determined annually.

Portfolio

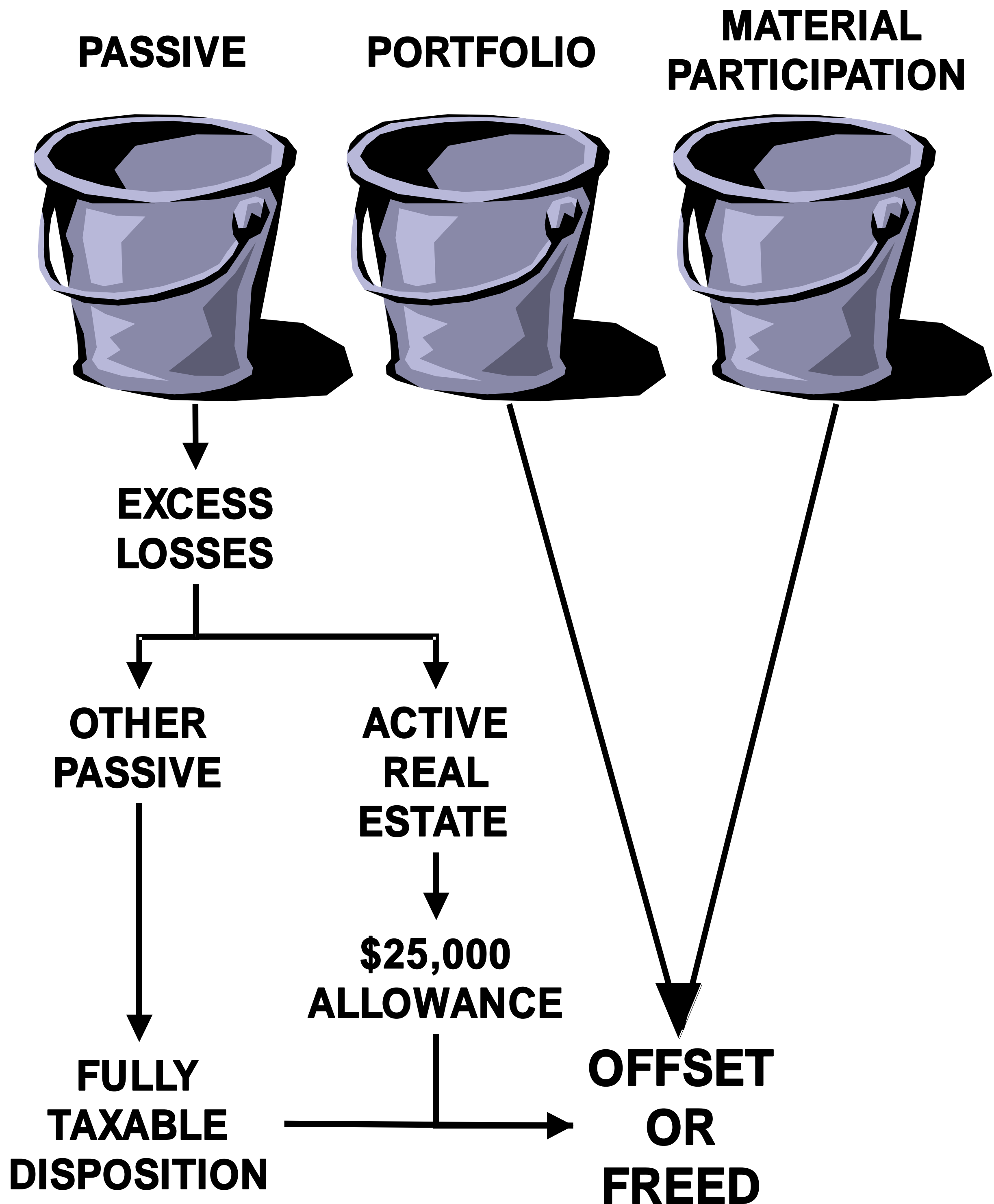
Annuity income, interest, dividends, guaranteed payments from a partnership for *interest on capital*, royalties not derived in the ordinary course of a trade or business, and gains and losses from disposal of related assets (e.g., those held for investment).

Passive

Income from a trade or business in which the taxpayer does not participate on a regular, continuous, and substantial basis (including nonbusiness activities under §212). Rental income from real or personal property generally is passive income, regardless of the taxpayer's level of participation. Exceptions are made for rental income from activities where *substantial services* are provided (i.e., hotel, motel, or other transient lodging and income from equipment rentals to various users or short periods). Limited partnership income is presumed to be passive income for a limited partner.

Suspended Losses

Usually, passive activity losses can be offset only against passive activity income. In determining the net passive activity loss for a year, losses and income from all passive activities are aggregated. The amount of suspended losses carried forward from a particular activity is determined by the ratio of the net loss from that activity to the aggregate net loss from all passive activities for that year. A special rule for rental real estate (discussed in the following section) allows a limited $25,000 offset against nonpassive income.


Passive Loss Big Picture
PASSIVE
PORTFOLIO
MATERIAL PARTICIPATION
EXCESS LOSSES
OTHER PASSIVE
ACTIVE REAL ESTATE
$25,000 ALLOWANCE
FULLY TAXABLE DISPOSITION
OFFSET OR FREED

Fully Taxable Disposition

A taxpayer making a taxable disposition of an entire interest in a passive activity generally takes a full deduction for suspended losses in the year of disposal. Suspended losses are deductible against income in the following order: income or gain from the passive activity, net income or gain from all passive activities, and other income. When a passive activity is transferred in a nontaxable exchange (e.g., a like-kind exchange or contribution to a partnership), suspended losses are deductible only to the extent of recognized gains. Remaining losses may be deducted on the disposal of the received property.

Rental Real Estate Losses

Up to $25,000 of passive losses from rental real estate can be offset by *individuals* against active and portfolio income in any one year. The $25,000 maximum is reduced by 50% of the difference between the taxpayer's modified adjusted gross income (AGI) and $100,000. Thus, when the taxpayer's AGI reaches $150,000, the offset is eliminated.

The offset is available to those who *actively* (rather than materially) participate in rental real estate activities. Active participation is an easier test to meet. It does not require regular, continuous, and substantial involvement with the activity, as does *material* participation. However, the individual must own at least 10 percent of the fair market value of all interests in the rental property and either contribute to the activity in a significant and bona fide way regarding management decisions or actively participate in arranging for others to make such decisions. Limited partners *cannot* meet the active participation test.

Example

Dan invests $50,000 in the ICBM Limited Partnership for an overall 10% interest in capital and profits as a general partner. Dan's interest in items to be shared exclusively among the general partners is 20%. Dan makes no other investments in passive activities during the year and has no carryover investments from prior years.

Shortly after Dan's investment, ICBM acquires rental real estate for $500,000 cash and a $1,000,000 recourse mortgage from Insecurity Bank & Rip-off Trust. Dan's share of the recourse debt (a general partner item) is $200,000, and his basis in the partnership interest is $250,000. Dan's share of the partnership loss in the first year of operations is $18,000. Dan's adjusted gross income before considering the loss is $75,000.

Assume Dan does not meet the requirements for material participation in ICBM but does meet the requirements for ac-

tive participation. Dan's loss deduction is not restricted by the general loss limitation rule (§704(d)), or the at-risk provisions (§465). Therefore, Dan may deduct the $18,000 loss against nonpassive income.

Example

Daphne contributes $20,000 to Up Their Rents Limited Partnership for a 10% limited partnership interest in capital and profits. The partnership then purchases rental real estate subject to a nonconvertible qualified nonrecourse mortgage of $150,000 from a commercial bank. Daphne has no other passive loss activities during the year.

Daphne's share of losses from the first year of operations is $27,000. Daphne's partnership interest basis is $35,000 [$20,000 cash plus (10% x $150,000 debt)], and her loss deduction doesn't exceed this amount (§704(d)). However, while the debt is exempted from the at-risk provisions, and it appears Daphne should be allowed to deduct the $25,000 loss share from portfolio or active income, the loss may not be offset against this income since Daphne is a limited partner and can never satisfy the active participation requirement for the passive activity loss deduction of $25,000.

Application to Corporations

Section 469 applies to personal service corporations and S corporations as well as to individuals and partnerships. It also applies in a more limited form to closely held C corporations, where more than 50% of the stock is owned by five or fewer persons. A closely held C corporation can subtract passive losses from its net active income but not from its investment income.

Review Questions

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73. Income from wages or salary is classified as:
   a. material participation.
   b. portfolio.
   c. passive.
   d. service generated.

74. Under §469, who would materially participate in a trade or business activity?
   a. a limited partner.
   b. a taxpayer incurring gains and losses on the sale of investment assets.
   c. a taxpayer involved in rental activities.
   d. a taxpayer involved in a business on a regular, continuous, and substantial basis throughout the year.

75. Under §469, what is deemed to be portfolio income?
   a. royalties received in the ordinary course of a business.
   b. rental income from hotel operations.
   c. limited partnership income.
   d. guaranteed payments from a partnership for interest on capital.

76. Under §469, passive losses can offset:
   a. active income.
   b. any portfolio income.
   c. interest income that is portfolio income.
   d. passive income.

77. Which of the following corresponds to the treatment of suspended losses?
   a. They are deductible first against net income or gain from all passive activities.
   b. They are deductible only to the extent of recognized gains.
   c. Amounts carried forward are based on the ratio of net loss from that activity to the aggregate net loss from all passive activities for that year.
   d. They are unrealizable until the partnership terminates.

78. Under §469, a taxpayer may be able to offset against nonpassive income up to $25,000 per year of passive rental real estate losses. To satisfy a requirement for this offset the:
   a. taxpayer must be a limited partner.

b. taxpayer must possess at least 10% of the value of the property.

c. taxpayer must have substantial, ongoing involvement in the rental activity.

d. taxpayer's adjusted gross income must be $300,000 or less.

79. Which of the following statements is correct regarding the active participation test for rental real estate losses?

a. Arranging for others to make management decisions regarding the rental activities may satisfy a requirement.

b. Meeting the requirements results in the ability to offset $100,000 of rental real estate losses against active income.

c. It is a more difficult test to meet than the material participation test.

d. It requires a participation level of 40% of the total hours related to the activity.

Learning Objectives

After reading Chapter 4, participants will be able to:

1. Determine capital asset treatment on the sale or disposition of a partnership interest under §741 by:

   a. Recognizing whether the Corn Products Rule applies and the reasoning behind the determination;

   b. Specifying the reasons why capital treatment is important and recognizing the impact of capital gain regulations on sales or exchanges of partnership interests; and

   c. Identifying the tax consequences of exchanges and transfers, and specifying partnership incorporation methods.

2. Recognize the tax treatment of a sale or exchange of a partnership interest where the partnership possesses hot assets (unrealized receivables and inventory), and identify the impact of partnership liabilities in computing both the amount realized on a sale of a partner's interest and the adjusted basis of the sold interest.

3. Specify optional basis adjustment provisions stating how they relate to the general rule for the inside basis after the transfer of a partnership interest, determine the tax consequences of making a gift of a partnership interest, and recognize the unique treatment of partnership interests that are abandoned or foreclosed on with or without related liabilities.

CHAPTER 4

Sales & Exchanges of Partnership Interests

Capital Asset Treatment - §741

A partnership interest is treated as a *capital* asset (§741). When it is sold or exchanged, gain or loss is recognized by the transferor partner. Such gain or loss is measured by the difference between the amount realized and the selling partner's adjusted basis in the partnership. It is capital gain or loss, *except* as provided in §751 - dealing with unrealized *receivables* and substantially appreciated *inventory* (§741).

Thus, a partner's interest, much like a shareholder's corporate holdings, can be sold or exchanged in whole or in part. As a result of applying the entity and aggregate concepts, the gain or loss that results from a disposition of a partnership interest may be fragmented into capital gain or loss and ordinary income or loss.

Corn Products Rule

The Corn Products rule is inapplicable to the sale of a partnership interest. Under Corn Products, an asset is *not* a capital asset if it is part of the integral operation of the business (*Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955)). However, §741 provides that a partnership interest is a capital asset; thus, Corn Products is *inapplicable* (*Pollack v. Commissioner*, 69 T.C. 142 (1977)).

Importance of Capital Treatment

As a result of recent legislation, a long-term capital gain is taxed at a much lower rate than ordinary income. Capital gain is essentially taxed at a 15% (or 20% if a high-income taxpayer) rate and ordinary income at a 37% maximum rate (2024). However, the deductibility of capital loss remains restricted (§1211(b)).

Capital Asset Treatment

- A partnership interest is treated as a capital asset (§741)
- Thus, except to the extent of unrealized receivables and inventory (hot assets), gain or loss is also capital
- Although the deductibility of capital loss remains restricted (§1211(b)), gain on partnership interests can enjoy recent reduced capital gains rates

Capital loss can be deducted up to the amount of capital gain plus $3,000 per year; *ordinary* loss is fully deductible. Thus the classification of a gain or loss as capital or ordinary remains important.

Regs on Gain on Sale of Passthrough Entities - §1(H)

The Service has issued regulations on the taxation of capital gains from sales or exchanges of interests in partnerships, S corporations, and trusts. The regs interpret the look-through provisions of §1(h) and explain the rules on dividing the holding period of a partnership interest. The regs reflect changes made to §1(h) by the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998 (REG-106527-98 (August 6, 1999)).

Under the regs, when a sale or exchange of an interest in a partnership, S corporation, or trust involves collectibles gain or §1250 gain, the amount of each type of gain is determined as if the entity had sold all of its collectibles or §1250 property in a fully taxable transaction immediately before the transfer. The regs provide special rules that apply when a partner, shareholder, or beneficiary recognizes less than all of the gain on the sale or exchange of the interest.

In applying §1(h)(7)(B), the regs provide that gain from the sale of a partnership interest that results in §1250 gain is not be treated as §1231 gain even if §1231 could apply to the disposition of the underlying property.

The regs also provide rules on the allocation of a divided holding period for a partnership interest. Generally, a holding period is divided if a partner acquires portions of an interest at different times or if an interest acquired in a single transaction has different holding periods under §1223. The holding period for a portion of a partnership interest is determined based on a fraction equal to the fair market value of the portion to which the holding period relates over the fair market value of the entire interest.

Finally, the regs permit a selling partner of a publicly traded partnership to use the actual holding period of the interest sold if (1) the interest is divided into identifiable units with ascertainable holding periods and (2) the selling partner can identify the portion transferred. (Reprinted with permission. Copyright 1999. Tax Analysts.)

Exchanges & Transfers

On occasion, partnership property or one's partnership interest might be involved in an exchange rather than a sale, such as when a partnership incorporates or when partners in more than one entity swap interests therein. The tax consequences of an exchange usually are the same as those of a sale. The distinction between sales and exchanges is important because certain exchanges qualify as *nontaxable* events.

Like-Kind Exchanges - §1031

An exchange of partnership interests does *not* qualify for nonrecognition under §1031 and, therefore, *is* equivalent to a sale. Section 1031(a)(2)(D) indicates that the like-kind exchange rules do *not* apply to the exchange of partnership interests.

Transfers to Controlled Corporations - §351

Section 351(a) provides that gain or loss is *not* recognized on the transfer by one or more persons of property to a corporation solely in exchange for stock in that corporation if, immediately after the exchange, such person or persons are in control (80% test) of the corporation to which the property was transferred.

Partner's Interest Basis

The transfer of a partnership interest to a corporation will be treated as a *nontaxable* exchange *if* the conditions of §351 are met. However, the transferor partner generally *recognizes gain* to the extent that any debt assumed by the corporation or debt to which the partner's interest is subject *exceeds* the interest basis (§357(c)).

> Note: When a cash basis partnership incorporates and normal operating debts (e.g., salaries and wages due employees, unpaid utilities, and rents due for the use of property) exist that *exceed* the basis of transferred property, the general rules of §351 trigger gain recognition. However, if such debt is either §736(a) income payments to a partner or an item that otherwise would be deductible, no gain is recognized.

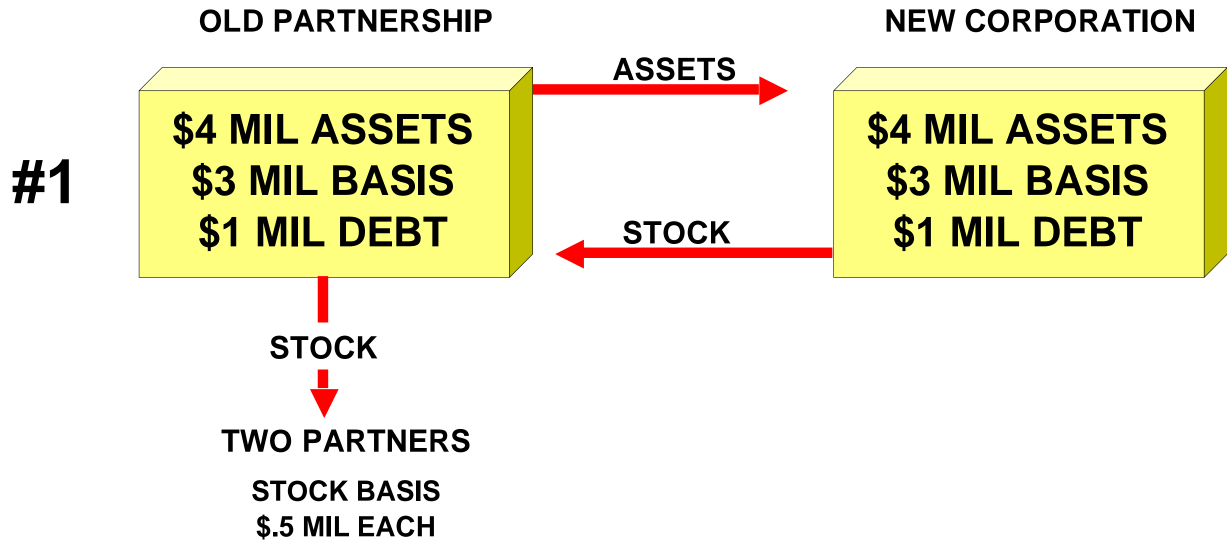
All items of partnership income or loss, deduction, or credit due to the transferred interest are *apportioned* between the transferor partner and the corporation. Moreover, if the partnership interest transferred represented 50% or more of the total interest in capital and profits, the partnership is *terminated*. When gain is recognized in the transfer of a partnership interest to a controlled corporation, determining its character requires an allocation similar to the *sale* of a partnership interest.

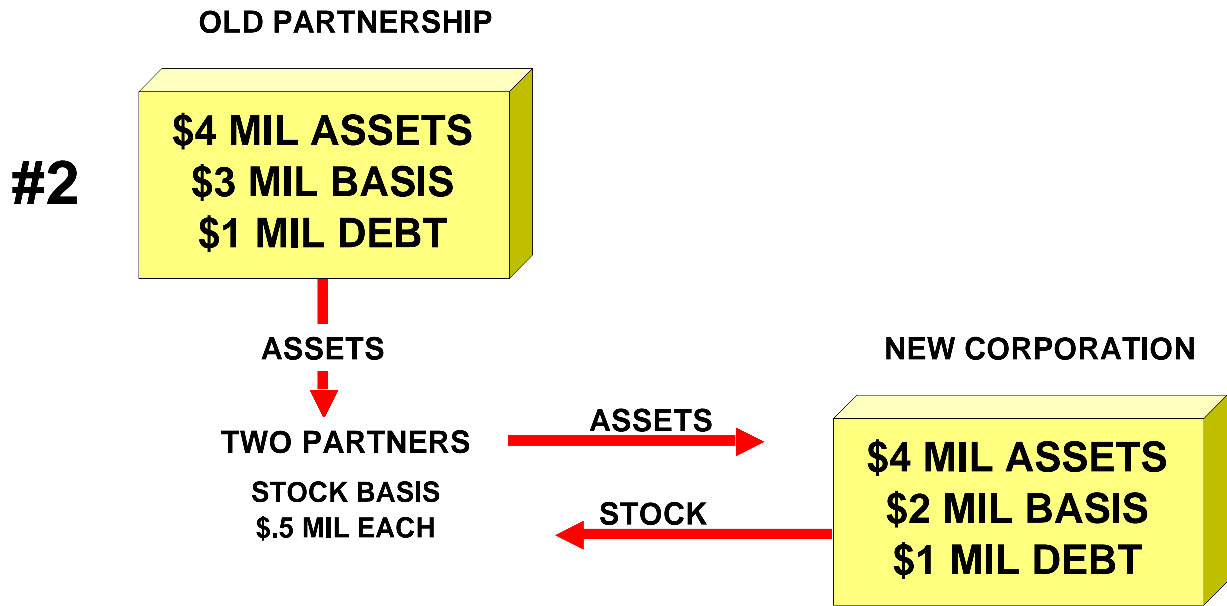
Incorporation Methods

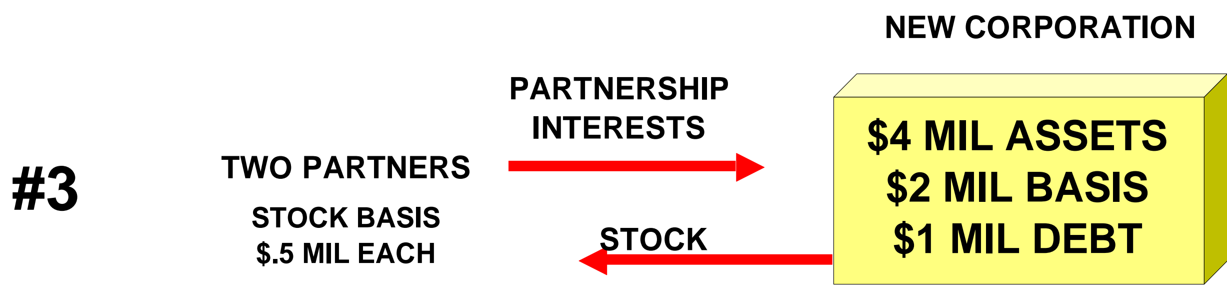
When partners decide to incorporate their business, at least *three* alternative methods might be used to accomplish the desired change in form:

1. The partnership transfers all its assets to the corporation in exchange for stock and the assumption of partnership liabilities. The stock then is distributed to the partners in proportion to their partnership interests.

INCORPORATION OF A PARTNERSHIP







2. The partnership makes a pro-rata distribution of all its assets and liabilities to its partners in complete liquidation. The partners then transfer their undivided interests in the assets and liabilities to the corporation in exchange for stock under §351.

3. Each partner's interest is transferred to the corporation in exchange for stock under §351. As a result, the partnership terminates, and the corporation owns all partnership assets.

If existing partnership debt was not created in a tax avoidance scheme and it does *not* exceed the basis of transferred assets, none of the three incorporation methods generate a recognized gain or loss. However, they do cause *different* tax results (R.R. 84-111). Thus, selecting the appropriate incorporation method is crucial.

If the corporation plans to issue §1244 stock, the original shareholders, not the partnership, must be partners. Otherwise, any ordinary loss benefits of the stock issue will be forfeited when the partners become shareholders.

If an S election is to be made by the corporation after the partnership's assets are received, such an election will be *invalid* if the partnership is the shareholder (Reg. §1.1371-1(e)). If the corporation is already in existence and operates under an S election, the election will terminate if the partnership is a shareholder.

Thus, when a partnership is to be incorporated with §1244 stock or an S election is desirable, the partnership should undertake methods (2) or (3) and make a pro-rata distribution of all its assets and liabilities to its partners in a complete liquidation. The partners then should transfer these items to the corporation in a §351 exchange.

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80. With the exception of unrealized receivables and appreciated inventory, how is a gain or loss on the sale or exchange of an interest in a partnership treated?

a. The gain or loss is recognized by the partnership.

b. The Corn Product rule applies.

c. The gain or loss is capital.

d. The gain or loss is ordinary.

81. Which of the following is a provision of the IRS's regulations regarding the taxation of capital gains from sales or exchanges of partnership interests, S corporations, and trusts?

a. A selling partner of a publicly traded partnership would not be allowed to use the actual holding period of the interest sold.

b. Gain from a sale of a partnership interest that results in a §1250 gain would be treated as a §1231 gain.

c. A fraction of the portion to the entire interest would be used to calculate the holding period for a portion of a partnership interest.

d. When collectibles gain is involved in the sale of a partnership interest, the gain is determined at year end.

82. In certain circumstances, a disposition of a partnership interest qualifies for nonrecognition of gain or loss. Which of the following qualifies for such nonrecognition?

a. A cash basis partnership incorporates with existing normal, operating debt that exceeds the basis of transferred property.

b. A partner disposes of the interest in a like-kind exchange.

c. A partner transfers property to a corporation in exchange for its stock, giving that person control.

d. A partner transfers an interest to a corporation and the debt assumed exceeds the basis of the interest.

83. The author describes three alternate methods for incorporating a partnership. What is one of these alternative methods?

a. distributing all assets and liabilities to partners in a complete liquidation with the partners selling undivided interests in the assets and liabilities to the corporation.

b. purchasing stock from the corporation, assuming partnership liabilities,

and then distributing stock to partners.

c. transferring all interests to the corporation in exchange for stock under §351.

d. transferring all partnership assets and liabilities to the corporation in exchange for stock.

Hot Assets - §751

A major *exception* to capital gain or loss treatment on the sale or exchange of a partnership interest arises when the partnership has *hot assets* that cause *ordinary* income to be recognized. When a partnership interest is sold, the consideration that is allocable to the partnership's *unrealized receivables* and substantially *appreciated inventory* becomes ordinary income to the selling partner (§751(a)). Thus, for this purpose, the partnership is treated like an aggregate rather than an entity; the consequences to the selling partner are the same as if he or she had sold the underlying assets instead of the partnership interest.

Unrealized Receivables

The term "unrealized receivables" generally includes receivables from the sales of ordinary income property *and* rights to payment for services. Sometimes the method of accounting, the nature of the property, or the property's holding period affects whether an item is an unrealized receivable. For instance, under the cash method of accounting, trade receivables from inventory sales and from services rendered (including related notes receivable) are included in the term, while under the accrual method they are not. The gain element in installment receivables from the sale of capital assets or §1231 assets is *excluded*, but that which relates to ordinary income is *included* in unrealized receivables (§751(c)).

Example

Restitutionary rights to payment for unbilled legal services are unrealized receivables. (Logan v. Commissioner, 51 T.C. 482 (1968))

Depreciation Recapture

Suppose the partnership owns assets on which depreciation would be recaptured as ordinary income if the partnership had sold the assets (§1245 & §1250). This recapturable depreciation *is* considered to be an "unrealized receivable" (§751(c)). Thus, on a sale of a partnership interest, the amount received that is allocable to the recapturable depreciation becomes *ordinary income.*

Inventory

The term "substantially appreciated inventory" includes virtually all partnership property *except* money, capital assets, and §1231 property (Reg. §1.751-1(d)). Specifically, the term includes inventory and other similar noncapital and non-§1231 assets.

"Inventory Items"

This term refers to any assets that, if sold by the partnership, would *not* be capital assets *or* property described in §1231. Thus, parcels of real property subdivided primarily for sale to customers in the ordinary course of business *are* inventory items (§1221(1), §1231(b)(1)(B); *Estate of Freeland v. Commissioner*, 393 F.2d 573 (9th Cir. 1968)). Accounts and notes receivable of an *accrual* basis partnership are also included in the definition of inventory under §751(d) since they are neither capital assets nor §1231 assets.

HOT! Assets

- **A major exception to capital gain or loss treatment on the sale or exchange of a partnership interest arises when the partnership has "hot assets" that cause ordinary income to be recognized (§751)**
- **When a partnership interest is sold, the consideration that is allocable to the partnership's unrealized receivables (including recapturable depreciation) and inventory becomes ordinary income to the selling partner**
- **When a partnership owns hot assets, partners who sell or exchange a partnership interest must promptly notify the partnership of such transfers**

This definition is *broad* enough to include all items considered to be *unrealized receivables* (Reg. §1.751-1(d)(2)(ii)). The disadvantage of including unrealized receivables in inventory can be seen when a determination is made on whether the inventory is substantially appreciated. Because unrealized receivables usually are included at a *zero basis* in the tests to determine if the inventory is substantially appreciated, they greatly enhance the possibility of this event occurring.

"Substantial Appreciation"

Appreciation in assets is "substantial" when the items have a fair market value in excess of 120% of *adjusted basis* (Reg. §1.471-4).

In applying this test, inventory items are evaluated as a *group* rather than individually. If there is substantial appreciation of all inventory items taken collectively, *each* item will be treated as substantially appreciated, even if a specific item has *not* appreciated at all.

Elimination of Substantial Requirement

The TRA '97 *eliminated* the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of partnership interests.

Note: The provision is effective for sales, exchanges, and distributions after August 5, 1997, with an exception for written binding contracts in effect on June 8, 1997.

Basis of §751 Property

Under §751, use *original asset costs*, without regard to special partnership basis adjustments, and inventory bid prices for quantities representing typical purchases. Thus, in making the necessary computations under §751, the basis of an unrealized receivable and of substantially appreciated inventory is the *same* as its inside basis. Of course, the inside basis for an unrealized receivable for rendering services would generally be *zero* (Reg. §1.751-1(a)(2); §732). The amount allocated to §751 items in the contract of sale of the partnership will generally be regarded by the IRS as correct (Reg. §1.751-1(a)(2)).

Example

The We R Retail Partnership is on a cash basis and has unrealized accounts receivable of $150,000. Dan's interest therein is $75,000. His outside basis is $200,000 and he sells it for $230,000. However, he first must allocate $75,000 of the sale price to the unrealized receivables, the basis of which is zero. Thus, Dan has $75,000 of ordinary income. The remain-

ing $155,000 of the sale price is allocated to the balance of the partnership interest. Dan has a $45,000 capital loss on the balance of his partnership interest ($200,000 less $155,000). (See Reg. §1.751-1(g) - additional examples)

Tax Reporting & Notification

When a partnership owns hot assets, partners who sell or exchange a partnership interest *must* promptly *notify* the partnership of such transfers. After the notification is received, the partnership *must* file an information return with the IRS for the calendar year in which such transfers took place. The return will contain the names and addresses of the transferors and transferees and such other information prescribed by statutory Regulations. In addition, each person whose name is shown on the calendar year return is to be furnished with the name and address of the partnership making the return and the information shown on the return as to such person. To avoid incurring any reporting penalties, Regulations under §6050K and §6678 should be consulted when hot assets are present and a partnership interest changes hands.

Effect

Thus, the ordinary income from the sale of assets held for sale to customers (see §1221(1)) *cannot* generally be avoided by the sale of a partnership interest. Formerly, if the assets had *not* appreciated in excess of 120% of basis, the ordinary income could have been transformed into capital gain through a sale of the partnership interest. Furthermore, even though the partnership had property that would produce a short-term capital gain, a sale of a partnership interest held over one year could still have produced long-term capital gain. This is no longer the case.

Liabilities of Partnership

In computing both the amount realized on the sale of a partner's interest *and* the adjusted basis of the sold interest, the selling partner *counts* partnership liabilities (§752(b), (d)). Likewise, the purchasing partner includes any assumed indebtedness as a part of the *consideration paid* for the partnership interest.

Example

Daphne sells her partnership interest for $200,000 cash. Her share of partnership liabilities was $80,000. Her amount realized is $280,000.

Example

Lazlo contributed $50,000 for a one-third interest in the accrual basis Fat Chance Partnership. During the aggregate period of membership, Lazlo's share of partnership income was $90,000. Over that same period, Lazlo withdrew $60,000. Lazlo's capital account balance is now $80,000, and partnership liabilities are $45,000, of which Lazlo's share is $15,000. Thus, Lazlo's inside and outside bases in the partnership are $95,000 ($80,000 capital account plus $15,000 share of partnership debts). Lazlo's partnership interest is sold to Raoul for $110,000 cash, with Raoul assuming Lazlo's share of partnership liabilities. The total amount realized by Lazlo is $125,000 ($110,000 cash received plus $15,000 of partnership debts transferred to Raoul). Lazlo's gain on the sale is $30,000 ($125,000 realized less an adjusted basis of $95,000).

What is Raoul's outside basis in the new No Chance With Raoul Partnership? Since Raoul did not contribute money or other property to the partnership, §722 does not apply. Raoul's outside basis equals $125,000 (cash paid of $110,000 plus assumed partnership debt of $15,000). Since there were no transactions with the partnership other than a name change, Raoul's inside basis equals Lazlo's old inside basis of $95,000.

Raoul's outside basis in the No Chance With Raoul Partnership is $30,000 greater than Raoul's proportionate share of the basis in underlying partnership assets (i.e., an amount equal to Raoul's $95,000 inside basis and the basis used to measure Lazlo's gain on the sale). To correct this discrepancy, Raoul may be entitled to a special basis adjustment under §743(b).

The general rules do *not* change even if the loan is nonrecourse and is secured by property worth *less* than the loan. The selling partner is *still* considered to realize the *full* amount of the loan (§7701(g); *Commissioner v. Tufts*, 461 U.S. 300 (1983)).

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84. Under §751, hot assets cause:

    a. ordinary income to be recognized.

    b. capital gain or loss treatment.

    c. the partnership to be treated as an entity.

    d. a pro-rata distribution of the assets.

85. The author provides several examples of items that are considered unrealized receivables. Which of the following items fail to qualify as unrealized receivables?

    a. assets on which depreciation would be recaptured as ordinary income if the partnership had sold the assets.

    b. gain elements in installment receivables from sales of assets other than capital assets or §1231 assets.

    c. trade receivables from services provided under the accrual method of accounting.

    d. trade receivables from inventory sales under the cash method of accounting.

86. Under Reg. §1.751, which of the following items fails to qualify as inventory items?

    a. accounts and notes receivable of an accrual basis partnership.

    b. capital assets.

    c. parcels of real property subdivided principally for sale in the ordinary course of business.

    d. unrealized receivables.

87. Which of the following is correct regarding substantially appreciated inventory?

a. If one item had not appreciated, none of the items were treated as substantially appreciated.

b. Items that have a fair market value in excess of 100% of adjusted basis are substantially appreciated.

c. Inventory items are evaluated individually.

d. Unrealized receivables usually are included at a zero basis in the substantial appreciation test.

88. Under §751, what is the relationship between the basis of substantially appreciated inventory and it's inside basis?

a. The basis plus special adjustments is greater than the inside basis.

b. The basis is less than the inside basis.

c. The basis is greater than the inside basis.

d. The basis equals the inside basis.

Inside Basis after Transfer of Partnership Interest

General Rule - §743(a)

Ordinarily, the inside basis of a partnership asset is *not* changed merely because a partnership interest has been sold or because of current or liquidating distributions (§743(a)). This rule can produce *inequitable* results.

Optional Basis Adjustment Provisions

§754	Permits a basis adjustment upon the transfer of a partnership interest or the distribution of partnership assets to a partner
§743(b)	Permits an acquiring partner a basis adjustment to his undivided interest in the partnership assets.
§734(b)	Permits the partnership a basis adjustment to its remaining property after a distribution
§755	Provides rules for allocating the basis adjustment among partnership assets.

Example

In a partnership owning a building with a basis of $30,000 and a fair market value of $90,000, Dan buys a one-third interest in the partnership for $30,000 (an amount equal to one-third of the value of the building). The price paid for the interest was based on fair market value, however, the building's depreciation is still determined on the partnership's basis of $30,000, and the new partner's share is only $10,000.

Special Inside Basis Adjustment - §754 & §743(b)

However, the Code provides that inside basis *can* be adjusted upon a transfer of a partnership interest. *If* the partnership makes an *election* under §754, inside basis will be adjusted *as to the partner who acquired the interest* so that it is the *same* as what that partner paid for the interest (§743(b)).

If an election under §754 is in effect and if a partner's interest is sold or exchanged, the partner dies, or a §761(e) distribution of a partnership interest is made, §743(b) provides that the partnership shall affect *one* of the following:

1. *Increase* the adjusted basis of partnership property by:

Transferee's interest basis in partnership $_______	
Less: Transferee's share of adjusted basis of all partnership property	(_______)
Increase	$________

2. *Decrease* the adjusted basis of partnership property by:

Transferee's share of adjusted basis of all partnership property	$________
Less: Transferee's interest basis in partnership	(_______)
Decrease	$________

The amount of the increase or decrease is an adjustment affecting the basis of partnership property *as to the transferee partner only*. For depreciation, depletion, gain or loss, and distributions, the *transferee partner* has a *special basis* for those partnership assets whose bases are adjusted. This special basis is the partner's share of the common partnership basis (i.e., the adjusted basis of such assets to the partnership without regard to any *special* basis adjustment of any transferee) plus or minus any special basis adjustments.

Example

The inside basis of assets in the hands of the Burns & Allen Partnership is $60,000. However, the fair market value of the

assets is $150,000. Dan purchases Burns' fifty percent partnership interest for $75,000. When the partnership makes the election provided in §§743(b) and 754, the inside basis is adjusted only as to Dan. It remains the same for Allen ($30,000) but is increased to $75,000 for Dan. Thus, if the partnership then sold the assets for their fair market value of $150,000, there would be a $45,000 gain to Allen but no gain or loss to Dan. This reflects that when he bought the interest, Dan paid the fair market value of the asset.

Allocation of Basis - §755

Section 755 provides that when a §754 election is made, the inside basis shall be adjusted, insofar as possible, so as to conform the bases of the assets to their *market values*. Moreover, the maximum amount of the basis adjustment is the excess of the purchase price over the buyer's share of the total basis of the assets (Reg. §1.755-1(c)).

Death of Partner

Sections 743(b) and 754 *also* apply when a partner dies. The person inheriting the partnership interest takes as his or her basis the fair market value of the partnership interest at the date of death (§1014). As to the legatee, the basis of partnership assets is adjusted if the election under §754 is made.

Basis Exception

No step-up in basis is allowed for *unrealized receivables*. An increase in basis of those assets would run counter to the policy of §691, relating to income in respect of a decedent (*Quick Trust v. Commissioner*, 54 T.C. 1336, aff'd, 444 F.2d 90 (8th Cir. 1971)).

Permanency of Election

The election operates *permanently* so that it might later involve a disadvantageous downward adjustment of the basis of partnership property upon later transfers of partnership interests.

Gifts

Generally, the gift of a partnership interest results in *neither* gain *nor* loss recognized by the donor. If the donor's entire interest in the partnership is transferred, all items of partnership income, loss, deduction, or credit attributable to the interest transferred are prorated between the donor and donee under §706(d).

Exceptions

Several exceptions exist to the general rule of treating gifts as nontaxable transfers. If the partnership uses the cash method of accounting and has accounts receivable at the time of transfer, the gift may be considered an anticipatory *assignment of income* by the donor. Similarly, if the partnership has installment notes receivable, the gift of an interest may be considered a disposition thereof (R.R. 60-352). In addition, if the donor's share of partnership liabilities exceeds the donor's basis in the partnership, the gift will be treated as part gift and part sale (R.R. 75-194). Because of these possibilities for gain or loss recognition, the donor should exercise caution in transferring a partnership interest by gift.

Abandonment or Forfeiture

Historically, an abandonment or forfeiture of a partnership interest is a rare event. The abandonment or forfeiture of a partnership interest results in an *ordinary* loss deduction when the partner's share of partnership debt is zero (*Gaius G. Gannon*, 16 T.C. 14 1134 (1951), acq. and *Palmer Hutcheson*, 17 T.C. 14 (1951), acq. However, partnership debt was not a problem in these cases.) Although a partnership interest is a capital asset, the abandonment loss generates an ordinary loss, because abandonment is not a sale or exchange. (*Edward H. Pietz*, 59 T.C. 207 (1972), and *Milledge L. Middleton*, 77 T.C. 310 (1981), aff'd per curiam in 82-2 USTC 9713, 51 AFTR2d 83-353, 693 F.2d 124 (CA-11, 1982). When the partner holds a share of the entity's debt, the abandonment is treated as a constructive distribution.

Review Questions

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89. Section 743(a) describes the general rule for the treatment of inside basis of partnership property resulting from a sale or distribution of a partnership interest. Generally, the inside basis of a partnership asset is:

a. changed only because of current or liquidating distributions.

b. not changed when a partnership interest is sold.

c. adjusted only for the partner selling the interest.

d. adjusted only for the partner acquiring the interest when a liquidating distribution occurs.

90. Which Tax Code provision allows a basis adjustment on a transfer of a partnership interest?

a. §691.

b. §743(b).

c. §754.

d. §755.

91. What is the effect on inside basis of a partnership's §754 election?

a. Inside basis is adjusted as to the selling partner.

b. Inside basis is increased by the transferee's interest basis in the partnership.

c. Inside basis is decreased by the transferee's share of adjusted basis of all partnership property.

d. Inside basis is the same as what was paid for the interest.

92. Under R.R. 60-352, how is a gift of a partnership interest treated if the partnership has installment notes receivable?

a. as a disposition.

b. as a nontaxable transfer.

c. as an anticipatory assignment of income by the donor.

d. as part gift and part sale.

Learning Objectives

After reading Chapter 5, participants will be able to:

1. Determine the treatment of distributions of cash or property by a partnership to the partners by:
   a. Recognizing the general nonrecognition rule under §731 and specifying exceptions to this general rule;
   b. Identifying a partner's basis on either a liquidating or a non-liquidating distribution under §§732 and 733, and specifying instances when a partner may choose a special basis adjustment when receiving a distribution of property other than cash influences how the partner's basis is determined; and
   c. Recognizing the tax consequences associated with proportionate and disproportionate distributions, particularly the effect of distributions of receivables or inventory.

CHAPTER 5

Partnership Distributions

General Nonrecognition Rule - §731

Ordinarily, the *distribution* of cash or property by the partnership to the partners is *not* a taxable event[1]. No gain or loss is recognized by a *partnership* on the distribution of money *or* other property to a partner (§731(b)).

> Note: If a partner is legally obligated to repay any deficit in his or her capital account, the deficit is treated as a loan, not a distribution. If the partner's obligation to repay is forgiven or canceled, the partner is considered to have received a distribution of money or property at the time of cancellation (Reg. §1.731-1(c)(2)).

Similarly, no gain or loss generally is recognized by a *partner* receiving such distributions, *except* that:

1. *Gain* is recognized by a partner to the extent any *money* distributed *exceeds* the adjusted basis of the partner's interest in the partnership immediately before the distribution (his or her "outside basis"). (§731(a)(1)) Thus, when the money distributed to a partner is *less* than the adjusted basis of the partner's interest, no gain is recognized to the partner, *even if* property worth *more* than the excess of the adjusted basis over the money distributed is also distributed (Reg. §1.731-1(a)).

    > Note: Any gain recognized is treated as gain from the sale or exchange of a partnership interest (§731(a)). The character of such gain is determined under rules previously discussed governing the sale of a partnership interest. A reduction in a partner's liabilities (due either to the partnership's assumption of them or a reduction in the partner's share of partnership liabilities) is treated as a money distribution (§752(b)).

[1] However, a distribution of unrealized receivables or substantially appreciated inventory may be taxable to the partnership.

General Nonrecognition Rule

- **Ordinarily, the distribution of cash or property by a partnership to its partners is not a taxable event (§731)**
- **However, gain is recognized by a partner to the extent any money distributed (including §752 debt relief) exceeds the adjusted basis of the partner's interest in the partnership**
- **Thus, when money distributed to a partner is less than the adjusted basis of the partner's interest, no gain is recognized to the partner, even if property worth more than the excess of the adjusted basis over the money distributed is also distributed (Reg. §1.731-1(a))**

2. *Loss* is recognized to the extent the adjusted basis of the partner's interest *exceeds* the sum of any money, and the basis to the distributee of any unrealized receivables and inventories received if the distribution is in *liquidation* of the partner's interest in the partnership *and* no other property is distributed. This is treated as a loss from the sale or exchange of the partner's interest (§731(a)).

> Election to Report Proportionately: Except for disproportionate distributions (discussed below), gain is not realized under the general distribution rule until the basis is first recovered, and loss is not realized until the final payment has been received. However, where the total retirement or death payments relating to the partner's property interest are a *fixed sum*, a retiring partner, or a deceased partner's successor may elect to report a proportionate part of the gain or loss each year. This election must be made in the first tax year for which a payment is received. A statement must be attached to that return indicating the election and showing the computation of the gain included in gross income (Reg. §1.736-1(b)(6)).

Exceptions to General Rule

There are several exceptions to the general rule on nonrecognition of a partner's gains or losses:

1. *Any* distribution within 7 years of the contribution to a partner contributing property with a basis different than its fair market value (see earlier discussion);
2. Distributions of property *contributed* by one partner to *another* partner within 7 years of the contribution (see earlier discussion);
3. *Liquidation payments* made to a retiring partner or to a deceased partner's successor in interest (see later discussion) as a share of income or as a guaranteed payment; and
4. A *disproportionate distribution* treated as a sale or exchange of property (see later discussion).

Basis Adjustments

Partner's Interest - §733

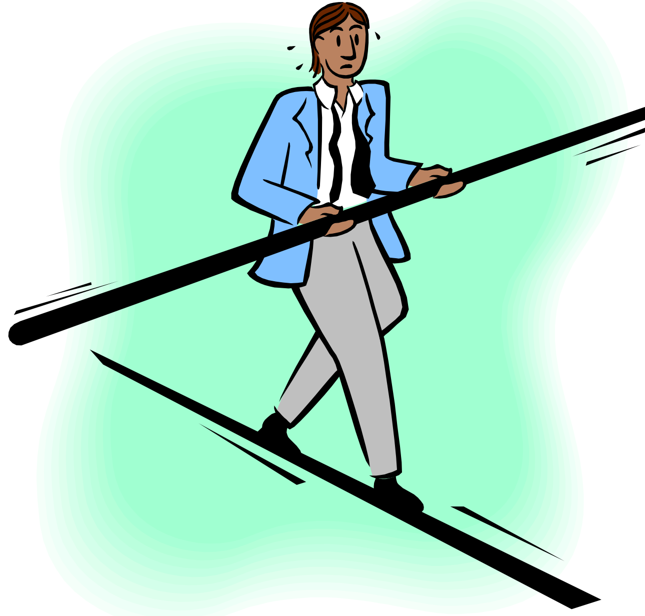
Nonliquidating distributions from a partnership *reduce* the basis of the distributee partner's *interest* (but *not* below zero) by:

(1) The sum of money distributed, *and*

(2) The basis to such partner of distributed property other than money.

Thus, the *outside* basis is reduced (but not below zero) by the amount of any money distributed to the partner and by the basis to such partner of distributed property other than money (§733).

Partner's Basis on Distribution



1. **Liquidating Distribution:** the basis of distributed property is the partner's adjusted basis in their partnership interest (**substituted** basis)
2. **Non-liquidating Distribution:** the basis of distributed property is the partnership's adjusted basis in the property (**carryover** basis)

Property Received - §732

Nonliquidating Distribution

The basis of *property* (other than money) distributed to a partner in a *non-liquidating* distribution is the asset's adjusted basis to the *partnership* immediately before the distribution. Thus, when a partnership distributes property other than money, the partner has the *same* basis in such property as the partnership had (§732(a)). Note, that the outside basis would be *reduced* by that *same* amount.

Basis Limitation - §732(a)

The basis of property received may *not* exceed the adjusted basis of the *partner's* interest *reduced* by any money received in the same transaction (§732(a)). The result may be that some of the basis of the distributed property could disappear[2].

Example

The adjusted basis of Mike's partnership interest is $10,000. He receives a nonliquidating distribution of $4,000 cash and property that has an adjusted basis to the partnership of $8,000. His basis for the distributed property is limited to $6,000 ($10,000 minus $4,000, the cash he receives).

Example

The adjusted basis of Dan's interest is $100,000. He receives a nonliquidating distribution of $80,000 cash and land with a fair market value and partnership basis of $30,000. His basis for the land is $20,000 ($100,000 adjusted basis of interest reduced by $80,000 cash distributed). He realizes no gain on the distribution.

Example

Dan's outside basis in Pleasure, Style & Hot Performance, a California partnership, is $200,000. The partnership makes a nonliquidating distribution to Dan of $120,000 cash and also beach property having an inside basis of $100,000 and a fair market value of $500,000. Dan first reduces his outside basis to $80,000 by reason of the cash distribution ($200,000 mi-

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[2] A §754 election might solve this problem

nus $120,000); he has no gain on the cash distribution. Then Dan takes into account the distribution of beach property by reducing his outside basis to zero. The property ordinarily would have a basis to Dan of $100,000 (the partnership's basis) but here the basis of the property to him is only $80,000 (Dan's remaining outside basis). The basis of $20,000 has disappeared (c.f., §754).

Liquidating or Complete Distribution

There is a *different* rule for distributions in *complete* liquidation. The basis of property received in *complete* liquidation of a partner's interest is equal to the adjusted basis of the partner's interest in the partnership, reduced by any money distributed to the partner in the same transaction.

Allocation of Basis When Limited - §732(c)

When the basis of distributed assets is *limited* by the partner's interest, an allocation of basis *must* be made. Under §732(c), basis is allocated to:

(1) Any unrealized receivables and inventory items in an amount *equal* to the partnership's adjusted basis for each such asset; *and*

(2) Any balance of the total basis to be allocated is assigned to any other distributed assets in proportion to their *adjusted basis* to the *partnership*.

Thus, when unrealized receivables or inventory is *not* involved, the remaining basis of the partner's interest is allocated to the assets in the ratio of their adjusted basis to the partnership.

Example

The adjusted basis of Ted's partnership interest is $30,000. In complete liquidation of his interest, Ted receives $10,000 in cash, inventory items having a basis to the partnership of $12,000, and two parcels of land having adjusted basis to the partnership of $12,000 and $4,000.

The basis of Ted's partnership interest is reduced to $20,000 by the $10,000 cash. This $20,000 basis is then divided among the properties he received. The inventory items in his hands now have a basis of $12,000. To divide the balance of $8,000, Ted adds the bases of the land ($12,000 and $4,000), and then takes 12,000/16,000 of $8,000 and 4,000/16,000 of $8,000. The bases of the two parcels of land in his hands are $6,000 and $2,000 respectively.

Partnership's Basis Greater Than Partner's Basis

If the adjusted basis to the partnership of the *unrealized receivables* and *inventory items* distributed to a partner is *greater* than the adjusted basis of the partner's interest (reduced by the money distributed to him or her in the same transaction), the amount of the basis to be divided among these items is in proportion to the *partnership's adjusted basis* of the items.

Example

Jenny's basis for her partnership interest is $18,000. In a distribution in liquidation of her entire interest, she receives $12,000 cash, inventory items having an adjusted basis to the partnership of $12,000, and unrealized receivables having a basis to the partnership of $8,000. The basis of her partnership interest is reduced to $6,000 by the $12,000 cash she receives. This $6,000 basis is divided proportionately between the inventory items and the unrealized receivables. Jenny's basis for the inventory items is $3,600 (12,000/20,000 of $6,000). Her basis for the unrealized receivables is $2,400 (8,000/20,000 of $6,000).

Partner's Basis Greater Than Partnership's Basis

If the basis of a partner's partnership interest to be divided is *more* than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed, and if *no* other property is distributed to which the partner can apply the remaining basis, the partner has a *capital loss* to the extent of the remaining basis of the partnership interest.

Special Adjustment to Basis

If a partner receives a distribution of property other than cash, the *partner* may choose a special basis adjustment if:

(1) The distribution is made within 2 years after acquiring any part of his or her partnership interest by a sale or exchange or on the death of a partner, *and*

(2) The partnership has *not* chosen the optional adjustment to basis.

If a partner chooses this special basis adjustment, the partner's basis for the property distributed is determined by assigning to the distributed property the *same* adjusted basis it would have had if the partnership had chosen the optional adjustment to basis. However, this assigned adjusted basis is *not* reduced by any depletion or depreciation that would have

been allowed or allowable if the partnership previously had chosen the optional adjustment.

Example

Bob purchased a 25% interest in X partnership for $17,000 cash. At the time of the purchase, the partnership owned inventory having a basis to the partnership of $14,000 and a fair market value of $16,000. Bob's purchase price reflected $500 of this difference ($16,000 minus $14,000 x 1/4). Thus, $4,000 of the $17,000 Bob paid was attributable to his share of the partnership inventory with a basis of $3,500.

Within 2 years after acquiring his interest, Bob withdrew from the partnership and received, in return for his entire interest, cash of $1,500, inventory with a basis to the partnership of $3,500, and other property with a basis of $6,000. The value of the inventory received was 25% of the value of all partnership inventories. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)

Since the partnership from which Bob withdrew had not chosen to make the optional adjustment to basis mentioned earlier, he chose to adjust the basis of the inventory received. His basis for the inventory is thus increased by $500 (1/4 of the $2,000 difference between the $16,000 fair market value of the property and its $14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of his new basis in the property, and not for purposes of partnership gain or loss on disposition.

The total amount to be allocated among the properties he received in the distribution is $15,500 ($17,000 basis for his interest less $1,500 cash received). The basis to Bob of the inventory items is $4,000 ($3,500 partnership basis plus $500 special adjustment). The remaining $11,500 is allocated to his new basis of the other property he received.

Mandatory Application

A partner does *not* always have a choice whether or not to use this special adjustment to basis. Whether or not property is distributed to a partner within 2 years after the acquisition of an interest, the special adjustment to basis *must* be made *if* the following conditions exist *when* the partner receives a partnership interest:

(1) The fair market value of all partnership property is more than 110% of its adjusted basis to the partnership;

(2) A division of basis among properties, upon a liquidation of the partner's interest immediately after the transfer, will shift basis from

property that does *not* qualify for depreciation, depletion, or amortization to property that *does* qualify; *and*

(3) A special basis adjustment, if chosen by the partnership, would have changed the partner's basis of the distributed property.

The special adjustment is only for the purpose of figuring the basis of the property to the partner receiving it.

Holding Period - §735

The holding period for property distributed in kind to a partner *includes* the period that the partnership held the property (§735(b)). If the partner contributed it to the partnership, the recipient partner's holding period also includes the period that the property was held by the contributing partner *before* the contribution (Reg. §1.735-1(b)).

Partnership Property - §754 & §734

If an election under §754 is in effect, the basis of *partnership* property is *increased* upon a distribution to a partner under §734 by the following:

(1) Any gain *recognized* by a *distributee* partner; and

(2) The *excess* of the adjusted basis of any distributed property to the partnership *over* the adjusted basis of that property in the hands of the distributee.

Conversely, the following decrease the basis of partnership property:

(1) Any loss *recognized* by a *distributee* partner; and

(2) For a *liquidating* distribution, the excess of the distributee's adjusted basis of any distributed property *over* the basis of such property to the partnership.

Basis Allocation on Properties Distributed By a Partnership

The TRA '97 modified the basis allocation rules for distributee partners so that the basis of distributed property is allocated generally in proportion to the fair market values of the property. The provision applies to partnership distributions after August 5, 1997.

Distributions of Receivables or Inventory

Proportionate Distributions

If a partner receives his or her *proportionate* share of partnership assets *in kind*, the distribution will *not* be treated as a sale or exchange. Even, if the partner receives, in-kind, his or her share of the partnership's *unrealized receivables* or *substantially appreciated inventory* items, the distribution of these items will *not* be treated as a sale or exchange.

Thus, when a partner's *proportionate* share of the *hot assets* is received in a distribution, §751 does *not* apply, and the general *nonrecognition* rule controls the tax consequences of the distribution.

Subsequent Disposition Rule

Although a proportionate distribution of hot assets may not *immediately* result in income recognition, any *later* disposition of unrealized receivables by the distributee partner triggers *full* ordinary gain or loss recognition. Similarly, a subsequent sale or exchange of inventory items triggers *ordinary* gain or loss recognition if the partner sells or exchanges such items within *five years* of the distribution date (Reg. §1.735-1(a)(2)). When the distributed inventory is held *over* five years, the character of any gain or loss is determined by the character of the property in the hands of the *distributee*. This rule applies to all inventory items *regardless* of whether they were substantially appreciated.

Example

Dan receives a proportionate share of inventory items (basis equal to $160,000) in a nonliquidating distribution from the partnership. Fourteen months later, Dan sells the property for $200,000. Even though a capital asset in Dan's hands, the $40,000 recognized gain is taxed as ordinary income. If the five-year holding period had been met, the $40,000 gain would have been a long-term capital gain.

Disproportionate Distribution - §751(b)

A distribution is "disproportionate" when a partner receives *more* than his or her proportionate share of partnership property in the first of the following categories and *less* than his or her proportionate share of property in the second category, *or* vice versa:

(1) Unrealized receivables (including recapturable deductions, certain transfers of franchises, trademarks, or trade names) and substantially appreciated inventory items; *and*

(2) Other property (including money).

In a disproportionate distribution, a partner, in effect, *sells* or *exchanges* part or his or her entire share in property of one category for property of the other category. Such a distribution normally results in *recognition* of gain or loss to the partner *and* the partnership. The general rules on partnership distributions apply to the *balance* of the distribution *not* treated as a sale or exchange (Reg. §1.751-1(b)).

Asset Allocation

The partners may *agree* on which particular assets in one category shall be considered sold or exchanged for particular assets in the other category. Absent such an agreement, a proportionate part of each asset *relinquished* in one category will be deemed sold or exchanged for the excess assets *received* in the other category (Reg. §1.751-1(g)).

Gain or Loss

Upon Distribution

When a distributee partner receives *more* than his or her share of unrealized receivables and substantially appreciated inventory items and *less* than his or her share of other property (including money), *he or she* is considered to have sold or exchanged the portion of his or her share of the *other* property that he relinquished *for* the *excess* unrealized receivables and substantially appreciated inventory items he received. His or her gain or loss is the difference between his or her basis for the other property relinquished and the fair market value of the excess unrealized receivables and substantially appreciated inventory items he or she received. His or her adjusted basis for the relinquished property is that which the property would have had if the distributee had received it in a separate current distribution immediately before the disproportionate distribution. The character of the gain or loss depends upon the character of the *other* property (Reg. §1.751-1(b)(2)(i),(iii)).

Similarly, if a partnership distributes *cash* to a partner in exchange for his or her interest in unrealized receivables or substantially appreciated inventory, the distribution is taxable to him or her as *ordinary* income to the extent of his or her transfer of an interest in those assets (§751(b)(1)(B)).

Note: Similar rules apply where the partner receives a disproportionate distribution of *less* than his or her share of unrealized receivables and substantially appreciated inventory items and *more* than his or her share of other property (Reg. §1.751-1(b)(3)(i), (iii); Reg. §1.751-1(g)).

The *partnership* (as constituted after the distribution) is considered to have sold or exchanged the excess other property distributed to the partner *for* the unrealized receivables and substantially appreciated inventory items he or she relinquished. Its gain or loss is the difference between its basis for those receivables and inventory items and the fair market value of the other property relinquished by the partner. This is an *ordinary* gain or loss that is allocated among the *nondistributee partners*.

Thus, if a partnership distributes unrealized receivables or substantially appreciated inventory to a partner, in exchange for their interest in other partnership assets, the *partnership* realizes ordinary income upon such distribution as if it had sold those assets to an outsider (§751(b)(1)(A)).

On Subsequent Sale

Gain or loss on a *later* disposition of unrealized receivables and inventory by a distributee partner is:

1. For unrealized receivables, ordinary gain or loss (§735(a)(1)).
2. For inventory items sold or exchanged within 5 years from the date of the distribution, ordinary gain or loss (§(a)(2)). If sold or exchanged after 5 years from the date of distribution, the character of the gain or loss depends upon the character of the item in the partner's hands on the date of disposition (Reg. §1.735-1(a)(2)).

Basis for Property Received in Disproportionate Distribution

When a partner receives a disproportionate distribution, that part of the property distributed to him or her that he or she is considered to have received in a sale or exchange has a *cost basis* in his or her hands (§732(e); Reg. §1.732-1(e)).

Exceptions

The disproportionate distribution rules apply to *all* distributions, both liquidating *and* non-liquidating except:

1. The rules of §751(b)(1) do *not* apply to a distribution of property that the partner *originally* contributed to the partnership.
2. They do *not* apply to payments to a *retiring* partner described in §736(a) (payments made to a retiring or deceased partner considered to be a distributive share or guaranteed payment), but they *do* apply to payments described in §736(b) (payments made in exchange for the interest of a retiring or deceased partner in partnership property). (§751(b)(2); Reg. §1.751(b)(4))

Effect

The effect of §751(b) is to take certain distributions *out of* the general rules of §731, which provide that most distributions are not taxable to the partnership or the partner. Instead, the distribution is made taxable to the partnership or the partner, depending on which of them sold an interest in the receivables or inventory. There is *no* problem if the partners receive a *pro-rata* distribution of cash, receivables, or inventory because then none of them has in-

creased or decreased his or her interest in the receivables or inventory (Reg. §1.751-1(b)(1)(ii)).

Example

Section 751(b) can be complex in operation. Mechanically, the regulations treat distributions covered by §751(b) as a "double distribution." Suppose Dan has an outside basis of $100,000 for his interest in a partnership and receives a $60,000 distribution in exchange for his interest in unrealized receivables which had an inside basis of zero. This is treated as if the partnership first distributed the receivables to Dan and then bought them back. The fictitious distribution of these receivables to Dan produces no gain to Dan or the partnership and the receivables have a zero basis in Dan's hands. Dan's outside basis remains $100,000. When Dan "sells" the receivables back to the partnership, he has $60,000 of ordinary income on the "sale." The partnership now has an inside basis of $60,000 for these receivables.

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93. Under §731 which of the following statements is correct?

a. Gain or loss generally is recognized by a partner receiving a distribution of money or other property.

b. If a distribution is in liquidation of a partner's interest in a partnership, loss is recognized.

c. A cash or property distribution by a partnership to its partners is a taxable event.

d. When a distribution of money to a partner is more than the adjusted basis of the partner's interest, the partner recognizes no gain.

94. When a partner receives a fixed sum for total retirement payments associated with the partner's property interest, the partner may elect to report a proportionate part of the gain or loss each year. What is required to make this election?

a. The partner must make the election every year the payments are received

b. The partner must notify the IRS of the first receipt of any retirement payments.

c. The partner must make the election in the first year for which a payment is received.

d. The partnership must compute the loss impacting gross income.

95. When a partner receives property in a complete liquidation of the interest in a partnership, what is the basis of property before the reduction for cash received?

a. the asset's adjusted basis to the partnership directly before the distribution.

b. the carryover basis.

c. the partner's adjusted basis in the interest.

d. the same basis as the partnership had.

96. When a partner receives a distribution of property other than cash, a special basis adjustment may be selected by the partner if two conditions are met. What is one of these conditions?

a. A division of basis among properties shifts basis to property that is eligible for depreciation, depletion, and amortization.

b. Within five years of purchasing the partnership interest, the distribution is made.

c. The fair market value of all partnership property is over 110% of its adjusted basis to the partnership.

d. The optional adjustment to basis has not been chosen by the partnership.

97. Under §751(b), which of the following events is treated as a sale or exchange?

a. in kind receipt of a proportionate share of the partnership's unrealized receivables.

b. in kind receipt of a proportionate share of the partnership's substantially appreciated inventory items.

c. receipt of a disproportionate share of partnership assets.

d. receipt of a proportionate share of partnership assets in kind.

Learning Objectives

After reading Chapter 6, participants will be able to:

1. Determine ways to liquidate a retiring partner's interest by:

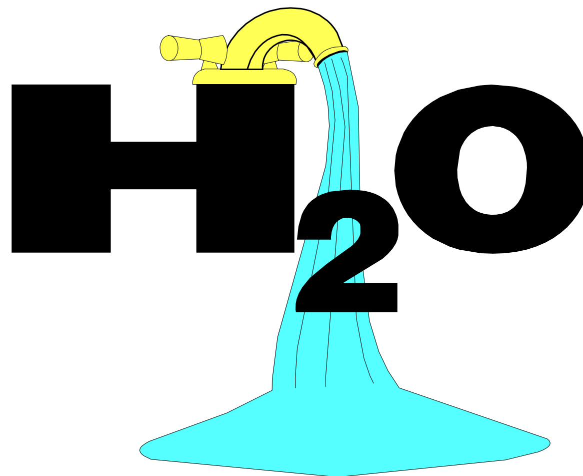
   a. Recognizing the types of liquidating distributions and specifying the character and treatment of cash distributions under §736; and

   b. Identifying the tax treatment of property distributions in liquidation permitting partnerships to distribute unrealized receivables or inventory.

2. Identify a withdrawing partner's basis when there are distributions in liquidation or in nonliquidation, and specify the requirements of a §754 election identifying additional adjustments required.

CHAPTER 6

Partnership Liquidations



Flexible Treatment

Distributions in *liquidation* of partnership interests get flexible treatment and have a dual character[1]:

1. Similar to all partnership distributions they can be treated as a *tax-free return of capital*. Unlike corporate shareholders, partners *may* be able to withdraw their investment *without* tax consequences[2].
2. Depending upon how the transaction is structured, a liquidating distribution may have the same effect as the *sale* of a partnership interest requiring the parties to recognize gain or loss.

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[1] However, entirely different rules apply if the interest is sold to another partner.

[2] Under the general rule, unrealized appreciation or depreciation in the market value of distributed partnership property is not recognized. Thus, the basis of such property is determined by reference to the property's basis in the hands of the partnership and the basis of the distributee partner's interest before the distribution.

Types of Liquidating Distributions

Liquidating distributions can take several forms. A partner's interest can be liquidated by a series of cash payments or a lump-sum distribution in kind. For example:

1. The cash payments may be based on the partnership's annual income or may be a guaranteed payment.
2. Distributions in kind may be a lump sum or one of a series in liquidation of a partnership interest.

Statutory rules differ as to liquidating distributions of money *and* distributions of other property.

Liquidating Distributions of Money

The character and treatment of liquidating distributions of money are governed by §736. Money payments are allocated between:

(1) Amounts paid for the partner's interest in partnership property under §736(b) *and*

(2) Other payments under §736(a). (Reg. §1.736-1(a)(2))

This allocation generally is made under the *partnership agreement*.

Section 736(a) Payments

Cash payments made to a retiring or deceased partner are, except as provided below, considered:

(1) A *distributive share* (i.e., income distribution), if they are determined *by reference to the partnership income*, thus reducing the amount of partnership income available to the continuing partners, *or*

(2) *Guaranteed payments*, if they are *not* determined by reference to the partnership income, thus producing a *deduction* from gross income to arrive at the partnership's taxable income.

The amount received is *ordinary income* to the *recipient* whether it is a distributive share *or* a guaranteed payment. If it is a distributive share, it also *increases* the recipient's outside basis by the amount of the distributive share; outside basis is then reduced by the amount of cash actually distributed. If it is treated as a guaranteed payment, it does *not* affect outside basis at all (§736(a)).

A payment described in §736(a) is treated as "income in respect of a decedent" and thus is fully taxable to a deceased partner's estate or other successor (§753; R.R. 66-325). The receiving partner includes the payments in gross income for the related partnership year that ends with or within the partner's year.

Section 736(a) Payments

Cash payments made to a retiring or deceased partner are:

- **a distributive share if figured by reference to partnership income, thus reducing the amount of partnership income available to the continuing partners, or**
- **guaranteed payments, if not determined by reference to the partnership income, thus producing a deduction from gross income to arrive at partnership taxable income**

Section 736(b) Payments

When the cash payment is made in *exchange* for the interest of the retiring or deceased partner in partnership property, it is treated as a current *distribution* (nonliquidating) by the partnership and *not* as a distributive share or a guaranteed payment.

Effect

Like other distributions, the *recipient* does *not* realize ordinary income. Liquidating cash payments under §736(b) are considered a return of capital to the extent of the partner's basis in the partnership, and *capital gain* is recognized to the extent of any excess. However, if substantially appreciated inventory is present, *ordinary income* is created in the year received (Reg. §1.736-1(a)(5)).

Thus, when cash distributed exceeds the recipient's outside basis, it creates capital gain and if it is less than basis, it generates a capital loss. There is *no* deduction to the *other* partners (§736(b)).

Exclusions From §736(b) Treatment

Section 736(b) payments do *not* include the following:

1. Payments for *unrealized receivables*. Payments in exchange for the partner's interest in unrealized receivables are subject to §736(a) *rather* than §736(b). (§736(b)(2)(A))

2. Payments for *goodwill* in excess of the partner's share of the goodwill's basis to the partnership that have not been specifically provided for in the partnership agreement. Thus, amounts received in exchange for the partner's interest in the goodwill of the partnership are taxed under §736(a) as *ordinary income*, rather than under §736(b) as made in exchange for the interest, *unless* the partnership agreement specifically provides for payment as to goodwill (§ 736(b)(2)(B)). If the partnership agreement provides for goodwill payments to a partner in excess of the partner's share of the partnership basis, such payments are *capital gain*. This reference *must* be specific (*Smith v. Commissioner*, 313 F.2d 16 (10th Cir. 1962)).

Note: Even if the partnership agreement failed to provide for a payment for goodwill, it can be modified and the modification will be given effect for tax purposes. The partnership agreement can be effectively modified at any time before the date on which the partnership return for the taxable year is due. Thus, even after the payment is made, the agreement can be retroactively amended up to the due date of the return (§761(c)). A modification to provide for a goodwill payment has been upheld (*Commissioner v. Jackson Investment Co.*, 346 F.2d 187 (9th Cir. 1965)).

Section 736(b) Payments

- When the cash payment is made in <u>exchange</u> for the interest of the retiring or deceased partner in partnership property, it is treated as a current distribution by the partnership and not as a distributive share or a guaranteed payment.
- Liquidating cash payments under §736(b) are considered a return of capital to the extent of a partner's basis in the partnership, and <u>capital gain</u> is recognized to the extent of any excess.

3. A payment in exchange for the partner's interest in substantially appreciated inventory would produce ordinary income rather than capital gain (§751(b)).

Liabilities

In making computations under §736, partnership liabilities forgiven or assumed by another party (or by the partnership) are treated as *cash* withdrawals. Normally, the amount included in the partner's basis for liabilities is the *same* as the amount considered withdrawn, and the two amounts "wash." When a partner's share of partnership liabilities *exceeds* the basis of the partner's interest, gain recognized can *exceed* the cash actually received. This occurs when the partners have withdrawn loan proceeds or when cumulative partnership losses have exceeded the partner's capital investment (exclusive of debts).

Series of Payments

When liquidating cash distributions are spread over several years, it is necessary to *allocate* the total amounts paid between §736(a) and §736(b) payments. If the partners have dealt at arm's length and specifically agreed to the allocation and timing of each class of payment, such an agreement *normally* controls the tax consequences.

In a series of §736 liquidating payments that eliminate a partner's entire interest, the question of imputed interest may arise. If unpaid amounts due to a partner are related to an arms' length loan to the partnership, the rules for below-market-rate loans *could* apply. However, if none of the payments are related to such a loan, apparently the unpaid amounts simply will constitute a §736(b) distribution or a §736(a) guaranteed payment (Prop. Reg. §1.7872-2(a)(1), (b)(3), -4(c)(1), and (c)(2) and Reg. §1.731-1(a)(1) and (c)(2)).

Contingent Payments

If the total amount of the liquidating payments is contingent on future events, then, absent a specific agreement to the contrary, *all* payments are considered as payments for an interest in partnership property under §736(b) until the total value of such interest has been paid (Reg. §1.736-1(a)(1)(ii) and (b)(5)(ii)). If the partners agree on the value of the retiring partner's interest in partnership property, the agreement *normally* controls for tax purposes.

Examples

Dan's outside basis in the Dan & Daphne Partnership is $200,000. Upon Dan's retirement, the partnership (as opposed to Daphne as an individual) purchases Dan's interest.

(a) The partnership (which has no unrealized receivables or substantially appreciated inventory) pays Dan $320,000 cash in exchange for his interest in partnership assets. Dan has a $120,000 capital gain; the partnership has no deduction. (§736(b))

(b) The partnership pays Dan $180,000 cash in exchange for his interest in the assets and an additional $70,000 that is not in exchange for his interest in assets. Dan has a $20,000 capital loss and $70,000 ordinary income (because the $70,000 payment is a guaranteed payment under §736(a)). The partnership has a $70,000 deduction.

(c) The partnership pays Dan $320,000 in exchange for his interest in the partnership's assets, of which $70,000 is in exchange for his interest in goodwill. However, the partnership agreement does not provide for any payment for goodwill. Dan has $70,000 of ordinary income and $50,000 of capital gain (because the payment for goodwill must be reflected under §736(a)). The partnership has a $70,000 deduction.

(d) Suppose in example (c) that the agreement did provide for a payment for goodwill. Dan then has a $120,000 capital gain and the partnership has no deduction.

(e) The partnership pays Dan $320,000 for his interest in partnership assets. However, $70,000 of those assets is unrealized receivables having a zero basis to the partnership. Dan has $70,000 ordinary income and $50,000 capital gain. The partnership has a $70,000 deduction. Payments for unrealized receivables must be reflected under §736(a).

(f) The partnership pays Dan $320,000 for his interest in partnership assets. However, $70,000 of this payment is in exchange for Dan's interest in substantially appreciated inventory having a basis of $40,000 to the partnership. Dan has $30,000 ordinary income and $90,000 capital gain because he is treated as if he had sold directly his interest in the inventory. (See §751(b)) The partnership has no deduction.

Mechanically, this result can be reached by using the fictitious "double distribution" technique described earlier (in Chapter 5). Using this approach, the partnership is treated as if it had first distributed the inventory to Dan. This fictitious distribution reduces Dan's outside basis from $200,000 to $160,000 and gives him a basis of $40,000 for the inventory. He is then treated as "selling" the inventory back to the partnership which produces $30,000 in ordinary income to Dan and gives the partnership a $70,000 basis for the "purchased" inventory. Finally, the remaining $250,000 cash distribution produces a

$90,000 capital gain ($250,000 less $160,000 in remaining basis).

Review Questions

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Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

98. When determined by reference to the partnership income, how are cash payments issued to a deceased or retiring partner treated?
    - a. as a distributive share.
    - b. as a guaranteed payment.
    - c. as increasing the amount of partnership income.
    - d. as a capital gain.
99. Cash payments that are determined without reference to the partnership income may be made to a retiring or deceased partner. What is the effect of these payments?
    - a. They increase the recipient's outside basis.
    - b. Outside basis is reduced by the amount of cash actually distributed.

c. They generate a deduction from gross income to attain the partnership's taxable income.

d. They reduce the amount of partnership income available to the continuing partners.

100. How is cash paid to a retiring partner in exchange for the partner's interest in partnership property treated?

a. as a distribution by the partnership.

b. as a distributive share, if computed with regard to partnership income.

c. as a guaranteed payment, if computed without regard to partnership income.

d. as ordinary income.

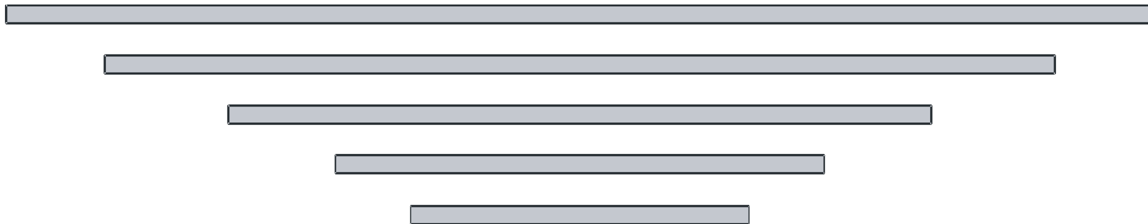
101. The effect of §736(b) payments varies depending on the character of the distribution. Which of the following payments are considered a return of capital?

a. liquidating cash payments in exchange for the partner's interest in substantially appreciated inventory.

b. liquidating cash payments for goodwill in excess of the partner's share of the goodwill's basis.

c. liquidating cash payments for a retiring partner's interest in partnership property.

d. liquidating cash payments for unrealized receivables.



Distributions of Property in Liquidation

In some situations, partnerships find it impractical or undesirable to liquidate a retiring partner's interest *solely* by cash distributions. Instead, some or all of the withdrawing partner's interest is liquidated through property distributions.

If the partnership does *not* have §751 property or if the distributions do not change the proportionate ownership of such property, the tax treatment of liquidating property distributions is essentially the same as *nonliquidating* distributions.

Thus, when a partnership distributes property in liquidation, there is usually *no* gain or loss recognized by the partner. The property received takes a basis equal to the *partner's* outside basis *less* any money *also* distributed (§732(b) & §731(a)(2)).

Example

In complete liquidation of a partnership, Dan, whose outside basis was $20,000, receives cash of $6,000 and land, whose inside basis was $29,000. The land's basis to Dan is $14,000 ($20,000 less $6,000). Note that $15,000 in basis has been "wasted" in this example (See §754 for a provision for conserving this basis).

Distributions of Unrealized Receivables or Inventory

If the partnership distributes unrealized receivables or inventory items to the partner in liquidation of his or her interest, their basis to him or her remains the *same* as it was in the hands of the *partnership* (§732). Here, the partner could realize a loss on the liquidation.

Example

Dan's outside basis is $20,000 and in complete liquidation of his interest, he receives $6,000 cash and unrealized receivables worth $18,000. The receivables had an inside zero basis and therefore Dan's basis for them is also zero. Thus, he has a $14,000 capital loss on the liquidation. (§731(a)(2)(B))

However, if the property distributed was a patent with an inside basis of zero (not an unrealized receivable or inventory item), he would not realize a loss. His basis for the patent

would be $14,000 (i.e., Dan's basis of $20,000 less the cash distributed).

Liquidating Disproportionate Distributions

A disproportionate distribution occurs when either less than *or* more than the partner's proportionate share of the partnership's unrealized receivables and substantially appreciated inventory is received. Although a partnership interest is a capital asset, remember that gain on the disposition of an interest attributable to unrealized receivables and substantially appreciated inventory is treated as *ordinary income*.

Section 751(b) provides that, to the extent (1) a partner receives hot assets in exchange for the partner's interest in other property or (2) a partner receives other property in exchange for the partner's interest in hot assets, the distribution is treated as a *taxable* exchange of assets between the partner and the partnership.

Section 751(b) may apply to any distributions of unrealized receivables or substantially appreciated inventory (whether or not in liquidation). This occurs, for example, when the distribution is not prorata among all partners.

Example

In the example above, if §751(b) applied, the partnership would be treated as if it had "sold" the receivable to Dan for $18,000 rather than distributed it. (This example assumes that $18,000 is the excess over Dan's prorata share of the receivables.)

Mechanically, under the §751 regulations, the partnership first fictitiously distributes $18,000 cash to Dan, reducing Dan's outside basis to $2,000. He takes the cash and "buys" the receivables. This produces an $18,000 gain to the partnership (which is taxed to the other partner(s), not to Dan). It also gives Dan an $18,000 basis for the receivables.

Finally, Dan is taxed in the usual manner on the $6,000 in cash he actually receives. It produces a $4,000 capital gain ($6,000 less $2,000 in remaining basis).

Basis of Distributed Property

Cash distributions reduce the withdrawing partner's basis dollar for dollar and are counted *before* subsequent or contemporaneous distributions of other property. The partner's remaining basis, after reduction by cash distributions:

(1) *First* is allocated to the distributed unrealized receivables and inventory (whether or not substantially appreciated) in an amount equal to the *partnership's adjusted basis* in such property, *and*

Note: If the partnership's bases in the receivables and inventory exceed the partner's remaining interest, the latter is allocated to such assets in the ratio of their adjusted basis to the partnership.

(2) Next, if the withdrawing partner has any basis remaining in the partnership after reductions for cash distributions and unrealized receivables and inventory, that basis is allocated to any other assets received, in the ratio of their *adjusted basis* to the *partnership*.

Gain or Loss Recognition

Gain is recognized only when the cash received *exceeds* the tax basis of the partner's interest. Loss is recognized only if the sum of the cash received plus the basis of distributed unrealized receivables and inventory is *less* than the adjusted basis of the partner's interest before the liquidating distribution and no other property is distributed.

As noted earlier, gain realized by the withdrawing partner on the subsequent disposition of inventory is ordinary income unless the disposition occurs more than five years after the distribution. Presumably, anyone who receives the inventory from the withdrawing partner as a gift or inheritance is not bound by the five-year holding period requirement. The withdrawing partner's holding period of all other property received in a liquidating distribution includes the partnership's related holding period.

Basis Adjustment after Distributions

Occasionally, the basis of property might be wasted in a distribution. In a distribution in *liquidation*, the partner cannot take as the basis for the distributed property any greater basis than his or her former outside basis (§732(b)). Similarly, in a *nonliquidating* distribution, basis of the assets ordinarily remains the same in the partner's hands as its former inside basis. However, basis could be lost if the inside basis exceeds a partner's outside basis (§732(a)(2)).

Election - §754

If an election is made under §754, the partnership increases the *inside basis* of the *remaining* partnership property by the amount of basis which would be *wasted* in the distribution (§734).

An election can be made under §754 for any year in which a transfer or distribution occurs by attaching a statement to a timely filed partnership return (includ-

ing extensions). An election is binding for the year for which it is made and for all subsequent years unless the IRS consents to its revocation. Permission to revoke generally is granted for business reasons, such as a change in the nature of the business or an increase in the frequency of interest transfers. Permission is not granted if it appears the primary purpose is to avoid downward adjustments to basis otherwise required under the election (Reg. §1.754-1).

Additional Adjustments Required by §734

Section 734 also requires a downward adjustment in the inside basis of remaining partnership assets if a distributee partner got a stepped-up basis for distributed assets. In addition, §734 permits an upward adjustment of remaining assets if a distributee partner recognizes gain on a distribution. However, it requires a downward adjustment if the partner recognizes loss on the distribution.

Review Questions

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102. A partnership may find it more feasible to distribute property in addition to cash in a liquidation of a retiring partner's interest. What effect does this have?

a. None of the withdrawing partner's interest may be liquidated through cash.

b. The property received takes a basis equal to the partner's outside basis.

c. Liquidating property distributions and nonliquidating distributions have the same fundamental tax treatment.

d. There is gain or loss recognition.

103. When determining a withdrawing partner's basis of distributed property from a liquidation:

a. any other assets received first reduce the basis dollar for dollar.

b. distributions of money reduce the basis dollar for dollar.

c. distributions of unrealized receivables are counted before subsequent and contemporaneous distributions of cash and other property.

d. the basis is allocated first to substantially appreciated inventory and then to inventory that is not substantially appreciated.

104. Gain may be recognized in a distribution of property in liquidation. Under which circumstance would gain be recognized?

a. on the subsequent disposition of inventory two years after the distribution.

b. if the adjusted basis of the partner's interest exceeds the cash received and the basis of distributed unrealized receivables and inventory.

c. when the amount of money received exceeds the tax basis of the partner's interest.

d. on the subsequent disposition of inventory when the inventory is received from the withdrawing partner as a gift.

105. In a nonliquidating distribution, what results when the inside basis exceeds a partner's outside basis?

a. A §754 election can be made to increase the outside basis.

b. A disproportionate distribution occurs.

c. Gain is recognized by the partner.

d. The partner could lose basis in the property.

106. A partnership must request permission to revoke a §754 election. When will the IRS deny the request?

a. for business reasons, in general.

b. if the main purpose is for an increase in the frequency of interest transfers.

c. if the main purpose is to avoid downward adjustments to basis.

d. if the main purpose is a change in the nature of the business.

Learning Objectives

After reading Chapter 7, participants will be able to:

1. Determine the taxation of limited liability companies recognizing the variety of tax entity choices and their advantages and disadvantages by:
   a. Specifying the advantages and disadvantages of an LLC recognizing the advantages of LLCs over C corporations;
   b. Identifying the advantages that LLCs have over S corporations and the differences between an LLC and a limited partnership; and
   c. Cite the drawbacks of LLCs and their bearing on entity choice.
2. Identify ways to use an LLC and their business-planning opportunities, and specify business ventures that should avoid LLCs.
3. Recognize the federal tax consequences of establishing an LLC by:
   a. Determining the role of check-the-box regulations in the entity characterization and identifying self-employment tax regulations and their application to LLC members;
   b. Specifying whether an LLC member is at risk for recourse debt and determine the treatment of debt discharge income on an LLC;
   c. Identifying the passive loss rules and their association with LLCs and selecting an appropriate method of accounting for an LLC based on its characterization; and
   d. Determining how an LLC can designate a tax matters partner for audit purposes.
4. Identify the dangers and tax consequences in converting to an LLC from another form of entity, and recognize the potential assessment of sales and use tax, real property taxes, and real property transfer taxes on entities on conversion to an LLC.

CHAPTER 7

Limited Liability Companies

Introduction

An LLC is a non-corporate business that provides its members with limited liability, a single shareholder tax, and the option to participate actively in the entity's management.

> Note: Members or designated managers are not personally liable for company debts in a limited liability company.

The Internal Revenue Code does not yet recognize an LLC as a distinct entity. Thus, depending on the state LLC statute, an LLC can be treated for tax purposes as:

(1) A partnership,

(2) An association taxable as a corporation, *or*

(3) A trust.

Although exhibiting the corporate characteristic of limited liability, the entity was usually treated as a partnership for federal tax purposes because it could be organized without continuity of life, centralized management, or free transferability of interests.

Check-the-Box Regulations

The IRS has released final regulations for entity classification, commonly known as the check-the-box regulations (Notice 97-1; TD 8697). The final rules allow entities that are not required to be classified as corporations (e.g., entities that have complied with the formal state law requirements to be organized as "corporations") to elect to be taxed as partnerships or corporations. This simplified regime, which applies to domestic as well as foreign business entities, replaces the existing fact-intensive classification regulations that are based on the historical differences between partnerships and corporations under local law (i.e., the "Kintner regs." under §301.7701).

Check-the-Box Election Maze Summary

DOMESTIC ELIGIBLE ENTITIES		
OWNERS	NO ELECTION	ELECTION
2 or more owners	Partnership	C Corporation
Single Individual Owner	Sole Proprietor	C Corporation
Single Corp. or Partnership Owner	Operation or Division	C Corporation

LLC Benefits

When a limited liability company is a partnership for tax purposes it can provide several benefits:

(1) Pass-through of tax attributes under the partnership tax rules;

(2) Limited liability to all members;

(3) Control over the business by the members without the risk that management participation will cost members their limited liability; *and*

(4) Freedom from S corporation eligibility requirements.

Advantages of LLCs over C Corporation

Double Tax

C Corporations pay an entity level federal and state income tax. The distributed income of a C corporation may be taxed twice as the shareholder is also taxed on dividends received from the C corporation. Perhaps the biggest benefit of the LLC over the C corporation is that the LLC is subject to one level of tax which is paid by the members of the LLC.

Note: C corporations may be subject to an accumulated earnings tax or a personal holding company tax. These taxes are not imposed on an LLC.

Basis Adjustment

A C corporation cannot adjust the tax basis of its assets in connection with a transfer of its shares. If the LLC makes a §754 election then the LLC can adjust the tax basis of its assets in connection with transfers of membership interests. If the LLC is holding assets with a fair market value in excess of basis, the availability of such an adjustment may be valuable and may help the transferring member to obtain a higher price for his or her interest.

In addition, the basis of the member's interest in an LLC and the S corporation is increased by the corporation's profits (or reduced by losses). The basis of the C corporation shareholder in his or her stock investment is not affected by the profits of the corporation which means upon sale the C corporation shareholder will pay tax on the value of earnings retained in the C corporation.

Special Allocations

A C corporation may not specially allocate income or loss to its shareholders. An LLC, because it is treated as a partnership for income tax purposes, may specially allocate income or loss within the provisions of §704(b).

Advantages of an LLC

- Similar advantages to limited partnership
- Special allocations available
- Good asset protection
- Separate legal entity
- No restriction on number of members
- Tax consequences flow thru
- Members can employ managers
- Valuation discounts
- Tax free liquidations
- Pass through of entity debt

Contributions

Corporations cannot receive tax-free contributions of property unless, immediately after the contribution, the contributor (alone or with others making contributions in related transactions) holds at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. LLCs generally can receive tax-free contributions of property from any member.

Liquidation

A C corporation is subject to a double tax on liquidation. An LLC generally can be liquidated without triggering any adverse tax consequences to the members.

Unreasonable Compensation

C corporations often run the risk of having shareholder salaries characterized as "unreasonable compensation" and disallowed. The unfortunate consequence of this result is that the payment is taxed as a dividend. The LLC does not run such a risk as it is generally irrelevant to the Service whether the member takes the payment as salary or distributive share of the LLC income under §701.

Non-Tax Benefits

Other non-tax advantages include the following:

(1) LLCs may provide members with unique economic, voting, and other rights without creating a second class of stock;

(2) The rights of shareholders can be modified by amending the LLC's operating agreement which is not publicly filed;

(3) LLC managers can be elected according to the procedure set forth in the operating agreement; and

> Note: C corporations must generally allow their shareholder to use cumulative voting in the election of directors. Cumulative voting is designed to allow minority shareholder interests to obtain board representation.

(4) LLC members are not susceptible to a piercing the corporate veil attack solely as a consequence of the members' failure to satisfy certain administrative formalities such as annual meetings and election of Board of Directors.

Advantages of LLCs over S Corporations

S corporations operate under many restrictions that are not applicable to LLCs. These restrictions include the following:

(1) S corporations are limited to 100 shareholders;

Note: There are no restrictions on who may be a member of an LLC or on the number of members.

(2) S corporations are limited to a single class of stock;

Note: LLCs can have multiple classes of stock outstanding and an infinite variety of interests.

(3) S corporations cannot have a shareholder that is a corporation, partnership, LLC, or unincorporated entity other than a qualified estate or trust;

Note: LLCs can have any form of entity as a member. This flexibility will provide a significant advantage to C corporations that can only get the benefit of losses reported by subsidiaries through filing a consolidated return.

(4) S corporation cannot have a shareholder who is a nonresident alien individual;

Note: LLCs can have nonresident alien members.

(5) S corporations have restrictions on the ownership of another corporation's stock;

Note: LLCs can own any amount of corporate stock.

(6) S corporation shareholders cannot include indebtedness of the S corporation in basis;

Note: The tax basis of an LLC membership interest includes the member's share of the entity's indebtedness that may shelter from current gain recognition any operating distributions of cash.

(7) S corporation cannot make a §754 election to increase the tax basis of its assets in connection with a transfer of its shares; and

Note: On the death of a shareholder or sale of stock an LLC can elect to adjust the basis of its assets.

(8) S corporations that are doing business in California must pay a 1.5% net income tax.

Note: LLCs are not subject to this tax, but must pay an entity level fee based on gross receipts. If the business operates at a loss, the S corporation form is generally preferable. If the entity operates at a profit, then the LLC will generally result in a lesser tax liability.

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107. Prior to the IRS issuance of the entity classification regulations (Notice 97-1; TD 8697), limited liability companies were classified for federal tax purposes based on the:

a. number of members.

b. historical differences between partnerships and corporations.

c. membership agreement.

d. written determination of the members.

108. What does the author view as the largest benefit of an LLC over a C corporation?

a. An LLC is subject to one level of tax.

b. An LLC is applicable to any type of business.

c. An LLC is able to select any tax year.

d. An LLC is easier to convert to an S corporation.

109. What is another tax advantage that an LLC, classified as a partnership, has over a C corporation?

a. no state law filing requirements on the formation.

b. tax-exempt status.

c. limited liability.

d. special allocations.

110. What is a possible advantage that S corporations have over LLCs?

a. S corporations can have a partnership as an equity owner.

b. S corporation equity owners can include S corporation debt in basis.

c. S corporations can have multiple classes of stock.

d. S corporations have been in existence longer and have a more developed case law and regulatory database.

Advantages of LLCs over Limited Partnerships

Limited partnerships must have at least one general partner that is subject to unlimited liability. LLCs are not required to have a general partner. In addition, limited partners who participate in the management of the limited partnership can be classified as general partners and lose the benefit of limited liability. All

members of an LLC can fully participate in management without jeopardizing their protection from such liability.

Outside Basis & Debt Share Advantage

When an LLC is deemed to be a partnership then it is subject to partnership taxation provisions. Partnership taxation provides that an increase in a partner's share of the partnership's liabilities is treated as a contribution of cash by the partner to the partnership resulting in a higher tax basis for the partner. This higher tax basis permits the partner to deduct greater pass-through losses and receive distributions tax-free.

A partner's share of a partnership liability depends on whether the liability is a *recourse* liability or a *nonrecourse* liability (§752). A recourse liability is where the partner bears the economic risk of loss. A partner's share of a recourse liability is that portion of the liability for which the partner bears the economic risk of loss.

A nonrecourse liability is where no partner (or related person) bears the economic risk of loss. Generally, a partner's share of nonrecourse liability is based on the partner's share of partnership profits. In a limited partnership, the general partners normally bear the entire risk of loss for recourse liabilities, and the limited partners' basis for those liabilities is therefore zero.

In a limited liability company, no member is personally liable for the LLC's liabilities, except to the extent of their investment in the LLC (R.R. 88-76). Thus, no member of an LLC bears the risk of loss for the LLC's liabilities whether recourse *or* nonrecourse[1].

> Note: Generally, an LLC is formed by filing Articles of Organization. This filing notifies creditors of limited liability. LLC members are jointly and severally liable for any liabilities accrued before the filing (or in the absence of the filing).

Since even recourse debt can be treated as nonrecourse, LLC members share in the LLC's liabilities based on their share of profits (i.e., the same rule used to determine a partner's basis in partnership nonrecourse liabilities). As a result, LLC members can have larger tax bases than if they had formed the business as a limited partnership.

> Note: A taxpayer's ability to use losses from the LLC may also be limited under the at-risk rules or the passive activity loss rules.

This conclusion opens several related tax issues involving debt.

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[1] What makes this treatment odd is that the lender may regard the debt as recourse debt; the lender may have the power to take other assets of the LLC in the event of default, just like a corporation.

Substantial Economic Effect Rules - §704(b)

Section 704(b) requires that disproportionate special allocations to partners have substantial economic effect. The §704(b) rules track the outside basis principles of §752 and in the allocation of interest turn upon whether a loan is recourse or nonrecourse. Since LLCs have the potential to make all loans nonrecourse, guidance is needed to calculate nonrecourse deductions that are intended to be specially allocated.

Discharge of Indebtedness Income

If a property transfer accompanies debt relief, a *taxable disposition* has occurred. For *nonrecourse* debt, the *entire* debt is included in the amount realized regardless of the property's fair market value. Thus, the debt relief does *not* generate income eligible for §108 exclusion. With the unsettled treatment of LLC debt, the question arises as to how that debt will be characterized for purposes of the debt relief rules.

Advantages of LLCs over General Partnerships

LLC members are not personally liable for the debts and obligations of the entity. LLCs can restrict management powers to a subset of the members or to nonmember managers. General partners are fully liable for the debts of the partnership. Management of a general partnership is vested in the general partners who act in a fiduciary capacity vis a vis the partnership.

Disadvantages

The great disadvantage of an LLC is that they are so new. When an LLC is established in one state but does business in another state that has *no* LLC statute, liability protection can be *lost*. State tax treatment in the other jurisdiction may also be unclear. Moreover, many basic federal tax issues are unsettled.

There are still uncertainties with respect to the operation and taxability of the LLC. At the federal level, there are only a handful of private letter rulings and revenue rulings that discuss issues related to classification. Proposed regs have recently been issued regarding self-employment taxes, but many federal issues remain unresolved.

> Note for Californians: On or before January 1, 1999, the FTB will review the revenue impact caused by LLCs and adjust the computation of the fee accordingly. Each year after 1999, the FTB will conduct the same analysis and adjust the fees accordingly.

Other disadvantages include:

Disadvantages of an LLC

- **Uncertainty of self-employment taxes**
- **Restricted to certain businesses & professions**
  - **See California "death" list**
- **Additional taxes & filing fees**
  - **See California "gross" receipts tax and $800 filing fee**
- **Must use the calendar year**
- **Cancellation of indebtedness may stick to member**
- **Recourse and nonrecourse debt issues**

(1) Some state LLC statutes (e.g., California) severely restrict the types of businesses that may elect to form as LLCs;

(2) Managers who are actively involved in the management of the LLC will be subject to self-employment tax;

> Note: Inactive LLC members can be treated as managers and their distributive share of the LLC's income will be subject to self-employment tax if the LLC does not designate managers to operate the business.

(3) The nontaxable fringe benefits available to LLC members are the same as those available to partners in a partnership;

> Note: LLCs are not afforded any of the exclusions for cafeteria plan benefits under §125. In addition, LLCs cannot issue equity interests or options to acquire equity interests that qualify for tax-preferred treatment under the rules applicable to corporate incentive stock options and employee stock purchase plans.

(4) The risk of inadvertent termination is higher in the LLC as certain procedural requirements must be met in order to continue the LLC in the event of bankruptcy, death, resignation, or withdrawal of a member;

(5) LLCs must generally have the same tax year as the members of the LLC and, as a result, most LLCs will be restricted to a calendar year.

(6) Nonresident members of the LLC will be taxed on their California source income, while nonresident shareholders in a C corporation are not taxed by California on dividend distributions; and

(7) California LLCs are required to pay the $800 minimum franchise tax plus a fee that is based on gross receipts.

> Note: If the LLC operates at a loss then the payment to California will be greater than the payment required from an S corporation that pays a 1.5% income tax or the $800 minimum tax imposed on limited partnerships. Although the fee is deductible, it is not creditable against other states' income taxes for foreign LLCs doing business in California.

Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

111. Limited liability companies can have advantages over limited partnerships. For example, limited partners involved in running the limited partnership can be classified as:

  a. managing partners and lose the ability to pass through losses.

  b. members

  c. general partners and lose the benefit of limited liability.

  d. silent partners.

112. In a limited liability company treated as a partnership, all entity debt is essentially:

  a. recourse.

  b. nonrecourse.

  c. assumable.

  d. subordinated.

113. What is one advantage that LLCs have over general partnerships?

  a. LLCs are not subject to disclosure, recordkeeping, and reporting requirements.

  b. LLCs can restrict management powers.

  c. Managers who are actively involved in the management of the LLC will not be subject to self-employment tax.

  d. Nontaxable fringe benefits are available to LLC members.

114. Which of the following is a disadvantage of LLCs?
   a. Members' salaries are often typified as unreasonable compensation.
   b. They have a higher risk of inadvertent termination.
   c. They cannot have nonresident alien members.
   d. They cannot include indebtedness of the entity in basis.

Uses

Many business enterprises will use the LLC form effectively. This section describes some of the scenarios where the LLC will probably be most popular.

Professional Firms

Professional firms may benefit from conducting business as an LLC, particularly, by limiting malpractice liability for other professionals with whom one practices. However, LLCs do not protect a professional from liability for their own acts.

> Note: California has severe restrictions on professions that can use the LLC format.

When to Use an LLC

- If there will be only one member and you want to elect to be taxed as a sole proprietorship
- When you wish to avoid some of the restrictions of an S corporation
- If you want the benefits of a partnership, but need limited liability
- If you will be conducting foreign business operations

An LLC can also shield the members from the liabilities of the business. (including loans for working capital or furniture, fixtures, and equipment, and lease obligations), although, as a practical matter, the creditor will probably require personal guarantees.

LLCs can provide the members of a professional firm with:

(1) The limited liability permitted by law;

(2) Control over the firm without risking limited liability;

> Note: While most states provide that voting rights will be in proportion to members' contributions to capital, members are permitted to create different classes of interests.

(3) Freedom from the S corporation eligibility requirements; and

> Note: An S corporation is subject to the one-class-of-stock rules, and may not be used to provide preferences on distribution of profits. S corporations are limited to 100 shareholders and are subject to ownership limits.

(4) Pass-through taxation.

> Note: A regular corporation means entity-level taxation. However, regular C and professional corporations are eligible to use a flat 21% rate.

Venture Capitalists

Generally, venture capitalists want control over management, and sometimes even the decision-making process. They also want to retain limited liability and would prefer only one level of taxation. The limited partnership form will not allow involvement in management to any great extent, and the corporate form results in a double level of taxation. The LLC allows the venture capitalist to combine the desired elements of management control with the flow through benefits of the partnership. Now the venture capitalist can control events that will trigger the sale of assets or other rights without inheriting the duties of a corporate director.

Leveraged Buyouts - LBO

The typical leveraged buyout financing transaction attempts to substitute high-interest payments on debt for dividends to avoid the double taxation scheme inherent in the corporate tax system. The debt instruments used in a leveraged buyout often look like equity and run the risk upon audit of being reclassified as equity. Partnerships are not subject to the same scrutiny, as it makes no difference to the IRS whether the payments are characterized as interest or an allocation of profits. Therefore, the high-yield instruments do not pose the same risk of reclassification in the LLC entity as they do in the corporate form.

Additionally, the LLC member manager can be given a significant voice in management or increased voting rights if the firm fails to pay the interest on the debt

for the same reason. If the LLC runs into financial difficulty, the lenders already have a significant voice in the control of management and will be less likely to force the LLC into bankruptcy and risk further reshuffling of the ownership interests. The one drawback of the highly leveraged LBO vehicle is the restriction on the transfer of the membership interest in the LLC.

Joint Venture

The LLC also provides preferential tax treatment where two or more corporations plan to form a joint venture. If the corporations formed a corporate subsidiary then distributions would be eligible for the dividends received deduction, which provides tax relief for 70% or 80% of the dividend payment dependent upon the ownership interest in the subsidiary. The LLC, on the other hand, offers limited liability with only one level of taxation (equivalent to the benefit otherwise afforded by a 100% dividends received deduction). The co-venturers would save tax on 30% of the payments. The restrictions on free transferability are generally not a problem here.

Corporations Filing Consolidated Returns

Corporations currently filing consolidated returns may find the LLC alternative attractive. The corporation could retain the benefits of combining the LLC losses with its profits (as is currently available through the consolidated return) coupled with the benefit of limited liability. The benefits of the consolidated return would be preserved without the complexity often associated with filing a consolidated return. Additionally, the consolidated return benefits are only available to the corporation that owns 80% of the subsidiary. The LLC provides the benefits of consolidation to all investors.

Foreign Investment

The LLC provides an attractive alternative for foreign investment in the U.S., whether the investment is in real estate or some other business activity. The LLC provides the coveted feature of limited liability without which the foreign investor must rely on distance, unenforceability of foreign judgments, confidentiality, insurance, or a combination of some or all of these characteristics to avoid personal liability. In addition, LLCs are well understood in many foreign countries (where they are likely to be taxed as corporations). Accordingly, the LLC format may be attractive to entities doing business abroad or anticipating significant foreign ownership.

Note: Foreign individuals and entities may be members of a California LLC.

Real Estate Ventures

Real estate ventures typically are structured as general or limited partnerships in order to provide investors with the tax benefits of debt-financed depreciation deductions on a flow through basis. Often these investors do not need the non-taxable fringe benefits available to employees of C corporations. LLCs provide the benefits of flow through deductions without the unlimited liability risks associated with the general partnership.

Charitable Investment

Charities sometimes participate in fundraising ventures through limited partnerships. The transaction often finds the charity participating in limited partnership ventures either as the sole general partner or as one of several general partners. The charity needs to be involved in management to ensure that the partnership does not deviate from its charitable purpose. The problem faced by the charity is the conflict inherent in the partnership law versus the requirements of §501(c)(3). Under the partnership law, the general partner manages and assumes the overall risk of the venture. The general partner also undertakes a fiduciary obligation to the limited partners to use his or her best efforts to further the interests of the partnership. Under §501(c)(3) the charity must be organized and operated exclusively for the public, charitable purpose and not for the private benefit of the limited partners.

The LLC form provides an attractive alternative, as the liability is limited and the charity would not be required to undertake personal liability as a general partner. The LLC still allows the charity to maintain control over LLC activities to ensure that these functions are consistent with the charity's tax-exempt purpose.

Estate Planning

A common practice in estate planning is to consolidate family wealth in a partnership or S Corporation and then spread that wealth among family members by transferring ownership interest in the entity. This is much easier to accomplish with an LLC than with a partnership or S Corporation.

Because there are normally no limitations as to the number or types of LLC owners, complex trusts may be members of an LLC. Restrictions with respect to access to, and allocation and distribution of, income and principal can be placed in the trust agreement without considering the S corporation rules. Trusts of all kinds can be LLC members, while only very specific types of trusts may hold S corporation stock.

LLCs can use a flexible "master" trust with multiple beneficiaries as opposed to qualifying S corporation trusts that are limited to a single beneficiary. This significantly simplifies the structure and reduces administrative costs. Additionally,

modifications of existing estate plans to ensure compliance with the restrictions governing S shareholders on the death of a shareholder are avoided completely as there is no restriction on the number or type of members that are permitted.

LLC members can also take advantage of the §754 election to step up both inside and outside basis when stock is acquired at death or in a taxable transfer. Upon death, the S corporation shareholder receives only a step up in the basis of the stock itself ("outside basis") not the basis of the S corporation's assets ("inside basis"). If the LLC has a §754 election in place, the heirs' share of the assets held by the LLC will be assigned a tax basis equal to fair market value. This permits the heirs to obtain benefits from the basis step up without disposing of the LLC membership interest.

LLC membership interests can be made transferable via gift or otherwise through provisions contained in the LLC's operating agreement. Gifting membership interests can be significantly more convenient than gifting partial interests in assets, particularly real property. In addition, the organization documents can contain enough restrictions on access to the underlying assets that the donee has no more true control over his or her interests than he or she would under a trust.

One of the traditional benefits of using a holding company structure to accomplish intra-family wealth transfers is the ability to discount the value of a transferred asset for estate and gift tax purposes if it is a minority interest or is encumbered by meaningful restrictions on subsequent transfer.

California Valuation Problems

It may, however, be difficult to reduce the value of membership interests for gift tax purposes through the application of lack of marketability and minority interest discounts, unless the operating agreement modifies the default provisions of the California Act. If an LLC conforms to the default provisions of the California statute, then the withdrawal or death of a member would result in the dissolution of the LLC unless all of the remaining members voted to continue. Because a single member could cause dissolution of the LLC whenever there is an event of withdrawal with regard to any member (simply by voting not to continue the entity), the IRS likely would oppose any meaningful discount in the value of a membership interest. If, however, the operating agreement allowed the LLC to continue with a vote of at least a majority of the members then a single member could not cause dissolution and lack of marketability and minority interest discounts should be available.

An LLC is an ideal vehicle for distribution of family wealth, in that family disputes over assets held by the LLC can be resolved more easily by requiring in the

organizational document that disputes be arbitrated and that the member who brings an unsuccessful action pay the legal fees of the LLC in defending the action.

Problem Uses

The LLC form will often not be appropriate for the following business ventures:

(1) Existing businesses conducted in the corporate form,

> Note: Generally it will be too expensive to convert an existing corporation to an LLC.

(2) Operating companies whose stock is publicly traded; *and*

> Note: Generally these companies will not be able to qualify for partnership tax treatment, as they will exhibit the characteristic of free transferability of interests.

(3) Companies that intend to use traditional equity incentive plans (such as qualified stock option plans and stock purchase plans).

> Note: LLCs cannot issue equity interests or options to acquire equity interests that qualify for tax-preferred treatment under the rules applicable to corporate incentive stock options and employee stock purchase plans.

Federal Tax Consequences

The Internal Revenue Code does not explicitly address the tax classification of the limited liability company. Instead, the classification of the LLC as a partnership or an association taxable as a corporation is generally governed by the regulations issued under §7701(a)(3). Pursuant to Regulation §301.7701-2(a)(3), if an unincorporated organization (like an LLC) possessed more corporate characteristics than unincorporated characteristics, it constituted an association taxable as a corporation.

In interpreting §301.7701-2, the Tax Court, in *Larson v. Commissioner*, 66 TC 159 (1976) acq. 1979-1 CB 1, concluded that equal weight had to be given to four corporate characteristics and that for an unincorporated association to be treated as a partnership for tax purposes, it had to lack at least two of the following four corporate characteristics:

(1) Centralization of management,

(2) Continuity of life,

(3) Free transferability of interests, and

(4) Limited liability.

The IRS issued R.P. 95-10 that specified the conditions under which it would consider a ruling request related to classification of an LLC as a partnership for

federal tax purposes. In addition, the IRS released Notice 95-14 that stated that the Service was considering simplifying the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis.

Check-the-Box Regulations

The IRS has released final regulations for entity classification, commonly known as the check-the-box regulations (Notice 97-1; TD 8697). The final rules allow entities that are not required to be classified as corporations (e.g., entities that have complied with the formal state law requirements to be organized as "corporations") to elect to be taxed as partnerships or corporations. This simplified regime, which applies to domestic as well as foreign business entities, replaces the existing fact-intensive classification regulations that are based on the historical differences between partnerships and corporations under local law (i.e., the "Kintner regs." under §301.7701).

Among those entities classified as corporations under the final regulations are entities denominated as corporations under applicable law, associations, joint-stock companies, insurance companies, organizations conducting certain banking activities, organizations wholly owned by a state, and organizations taxable under provisions of the Code other than §7701(a)(3).

The regulations also contain a list of foreign entities that are treated as per se corporations. However, any entity that is not required by the regulations to be treated as a corporation is an eligible entity and may choose its classification. And, an eligible entity with two or more members can be classified as either a partnership or a corporation. A single member entity can be classified as a corporation or can be disregarded as an entity separate from its owner.

The final regulations have default classifications for eligible entities that will provide most entities with the classification they would otherwise choose. Therefore, in many cases, an actual election will not need to be filed.

For domestic eligible entities, the regulations adopt a passthrough default, and the default for foreign eligible entities is based on whether members of the entity have limited liability.

A foreign entity is classified as a partnership if it has two or more members and at least one of them does not have limited liability. A single-member entity whose owner does not have limited liability will be disregarded as an entity separate from that owner.

An existing entity's "default classification" status is the classification claimed by the entity immediately prior to the effective date of the regulations. An eligible entity's election of its classification may be made on Form 8832, *Entity Classification Election*.

The final regulations are effective as of Jan. 1, 1997. However, under a special transition rule for existing entities, the IRS will not challenge the prior classification of an existing eligible entity or an existing entity on the per se list for periods prior to the effective date of the regulations if:

(1) The entity had a "reasonable basis" for the claimed classification,

(2) The entity and its members recognized the federal tax consequences of any change in the entity's classification within 60 months before the regulations' effective date, *and*

(3) Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification was under examination.

The IRS is also notifying taxpayers of the effect of the final regulations on certain revenue rulings and revenue procedures. Effective Jan. 1, 1997, rulings and procedures are now obsolete to the extent that they use the prior classification regulations to differentiate between partnerships and associations. The IRS will publish a list of obsolete documents in the Internal Revenue Bulletin.

Self-Employment Tax

The IRS has released proposed regs with respect to how LLC members will be treated for purposes of self-employment taxes (Prop. Reg. §1.1402-(a)(18)). The issue posed a dilemma for taxpayers considering electing LLC status, as general partners are subject to the self-employment tax on their distributive share of the partnership's income and limited partners are not.

In PLR 9432018 the Service ruled that the members were subject to self-employment tax. In that ruling, all of the members actively participated in the LLC's business so it was unclear how the Service would rule where an LLC member did not actively participate.

Under the proposed regs a member's share of income or loss from the LLC will not be included in net earnings from self-employment if:

(1) The member is not a manager, *and*

(2) The entity could have formed as a limited partnership rather than an LLC in the same jurisdiction and the member could have qualified as a limited partner in that same jurisdiction.

The member will be deemed to be a manager if under the LLC's controlling documents (or the LLC statute) there are no designated or elected managers. In that case, all of the members will be deemed to be managers even if some members have more authority than others. The result will be that all of the members will be subject to self-employment tax.

> Note: The California statute's default provision will vest management in the members unless the Articles of Organization state otherwise. California's statute allows nonmembers to be managers. In this case, as long as the Articles of Organization provide for management by managers (members or

non-members), then the non-manager members should not be subject to self-employment tax.

The second requirement is intended to prohibit partnership treatment from being applied in cases where either the entity or the individual would not otherwise qualify for limited partnership treatment. The most obvious scenario would be where a limited partner participates in the management of the business. In this case, the limited partner may lose his or her status as a limited partner and become a general partner. If this is the case in the LLC, then the member may become liable for the self-employment tax, like a general partner.

For foreign jurisdictions, that do not have limited partnership statutes but have LLC statutes, the effect of the proposed regulation would be harsh. In these jurisdictions, the proposed regs would not permit any of the members of an LLC to be treated as limited partners for purposes of the self-employment tax.

The proposed regs have been roundly criticized because members who serve in the role of an investor could be subject to the self-employment tax, a result that would not accrue in a C corporation. Recommendations suggest that the focus of the regulation should be a facts and circumstances test that determines whether the member is performing services to earn the income derived from the ownership interest or whether the member has provided property to obtain that income. The test should consider whether participation in management by the member is to protect the investment (not self-employment), or participation that meets the obligations of the company to its customers and suppliers (self-employment).

Proposed Amendments to Limited Partner Regs - §1402

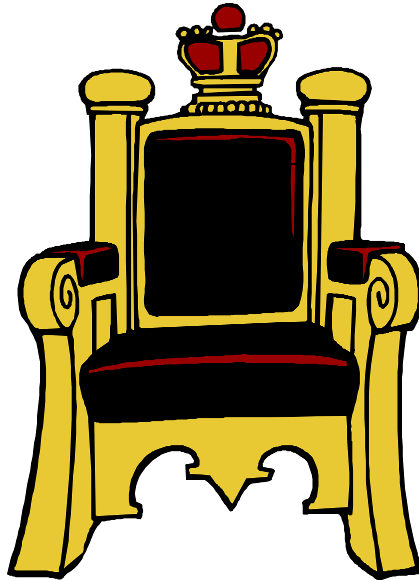
The IRS has issued proposed amendments (REG-209824-96) to the regulations relating to self-employment taxes imposed under §1402. These regulations were to permit individuals to determine whether they are limited partners for purposes of §1402(a)(13), eliminating the uncertainty in calculating an individual's net earnings from self-employment under existing law.

Note: These proposed regulations never became final. In 1997, the TRA '97 imposed a moratorium on the IRS issuing any regulations in this area until after July 1, 1998. This date has come and gone and the Service is yet to take any position.

The proposed regulations were to apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity. Thus, the same standards would apply when determining the status of an individual owning an interest in a state law limited partnership or the status of an individual owning an interest in an LLC.

Self-Employment Tax

"When the throne is empty only the sword rules"



- **A general partner's distributive share of partnership income is included in figuring net earnings from self-employment (§1402).**
- **Limited partners are not subject to the self-employment tax on their distributive share of partnership income (§1402(a)(13))**
- **However, the application of these rules to LLC members is in a state of confusion due to the '97 Act moratorium**

Generally, an individual would have been treated as a limited partner under the proposed regulations unless the individual:

(1) Had personal liability (as defined in §301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner;

(2) Had authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; *or*

(3) Participated in the partnership's trade or business for more than 500 hours during the taxable year.

If, however, substantially all of the activities of a partnership involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provided services as part of that trade or business would not be considered a limited partner.

The proposed regulations allowed an individual who was not a limited partner for §1402(a)(13) purposes to nonetheless exclude from net earnings from self-employment a portion of that individual's distributive share if the individual held more than one class of interest in the partnership. Similarly, the proposed regulations permitted an individual who participated in the trade or business of the partnership to bifurcate his or her distributive share by disregarding guaranteed payments for services. In each case, however, such bifurcation of interests was permitted only to the extent the individual's distributive share was identical to the distributive share of partners who qualified as limited partners under the proposed regulation (without regard to the bifurcation rules) and owned a substantial interest in the partnership. Together, these rules exclude from an individual's net earnings from self-employment amounts that are demonstrably returns on capital invested in the partnership.

At-Risk Rules - §465

A partner's deductible share of partnership losses is not only limited by the basis rules of §704(d) but also by the "at-risk" rules and the passive activity rules. The "at-risk" rules limit the deductible losses of the partner to an amount that includes only debt on which partners are considered to be "at-risk" (i.e. recourse debt). A member of an LLC will be considered "at-risk" to the extent of the amount of money plus the adjusted basis of any property contributed to the LLC and any income or loss generated by the LLC that flows through to the member. Distributions also reduce the at-risk basis. Debt is not included in the at-risk basis unless the member is personally liable on the note.

Although a general partner in a partnership is at risk for recourse debt, an LLC member will generally not be at risk on LLC debt. There is some conflict regarding whether the LLC member can include debt if the member personally guaran-

tees the loan. Generally, guarantees do not produce an at-risk amount if the guarantor acquires subrogation rights. In a partnership, the general partner would be liable to the guarantor who had to pay out on a partnership loan that went into default. However, in the LLC there is no member that is required to contribute in the event of default and therefore no subrogation right. If under state law there are no rights to recover from others, then the debt should qualify as at-risk debt to the LLC member.

Nonrecourse debt involving real property activities is eligible for special relief from the at-risk rules. For this exception to the at-risk rules to apply, the lender cannot be related to the taxpayer, the seller (or a person related to the seller), or a recipient of a fee received because of the sale. In general, the loan must be from a commercial lender and reflect an arms-length transaction. This type of debt is termed "qualified nonrecourse financing" and the members are treated as being "at-risk" for their share of the debt even if no member is personally liable. Where the loan is secured by real estate and does not hold any person personally liable for repayment, the loan qualifies as an exception to the at-risk rules. If the LLC incurs debt that is secured by real estate, this debt should qualify under this exception as no person is individually liable.

Debt Discharge Income

When a transfer of property accompanies debt relief, a taxable sale or exchange has occurred. If the debt is nonrecourse debt then the entire debt is included in the amount realized (regardless of the FMV of the property transferred (§7701(g)). Therefore, with nonrecourse debt (unlike recourse debt) none of that debt relief generates debt discharge income eligible for exclusion under §108.

Where the lender has recourse against the assets of the LLC (but not the personal assets of the LLC members), will that debt be treated as nonrecourse for purposes of the debt relief rules? Arguably, it should be recourse debt as such debt is not materially different than corporate recourse debt. However, because Subchapter K governs LLCs, the IRS may try to apply §752 principles and treat the debt as nonrecourse. Again, guidance is needed.

Passive Loss Rules - §469

Section 469(a)(1)(A) disallows a deduction for the passive activity loss of individuals, trusts, estates, personal service corporations, and closely held C corporations that do not materially participate in the activity. The test applied to determine material participation is different for individuals and limited partners.

In determining material participation, §469(h)(2) provides that "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially partici-

pates." A similar per se rule applies to prevent limited partners from claiming the $25,000 allowance for active participants in rental real estate.

Reg. §1.469-5T(e)(3)(I)(B) states that "a partnership interest shall be treated as a limited partnership interest if ... the 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,...." Although this broad definition in the regulations would arguably include LLCs, neither the regulation nor the statutory mandate for the regulation was ever intended to encompass LLCs. One can credibly argue that an entity must be a state law partnership before that regulation applies.

In addition, the limited partner per-se-passive rules were enacted because limited partners do not participate much in the business, and because limited partnerships were seen as the preferred vehicle for tax shelter losses (the evil that Congress wished to eradicate in the 1986 Tax Reform Act). Congress wanted to slam the door on limited partner losses. It did so with a per-se-passive rule. If limited liability alone were the motivation, then Congress presumably would have enacted similar per-se-passive rules for S corporation shareholders, regardless of their degree of participation in the business. LLC members, like S shareholders, can freely participate in the affairs of the business; therefore, like S shareholders, they should not be saddled by the limited partner per-se-passive rules under §469. Guidance is needed.

Method of Accounting

Four types of taxpayers are not permitted to use the cash basis method of accounting unless gross receipts are below a certain threshold. These taxpayers must use the accrual method of accounting. The four types of taxpayers subject to these restrictions include:

(1) C Corporations;

(2) A partnership that has one or more C corporations as a partner;

(3) Tax shelters; *and*

(4) Trusts that are subject to the tax on unrelated trade or business income but only with respect to such income (§448).

The term tax shelter is defined in the regulations to mean:

(1) Any enterprise if at any time 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;

(2) Certain syndicates; *and*

(3) Entities whose principal purpose is the avoidance of federal income tax (Reg. §1.448-1T(b)).

The California Act provides that every interest in an LLC will be a security unless the person claiming the exception can prove that all of the members are actively engaged in the management of the LLC. It is not clear where the line will be drawn between members actively engaged in the management of the LLC and members who assume a passive role with respect to the business of the entity.

Examples of situations where the analysis becomes unclear include:

(1) A member-managed LLC in which fewer than all of the members participate in the management of the business, although each member has the power to do so; *and*

(2) LLCs where only some management powers are delegated to member managers, while other powers are granted to all members.

Under the California Act, there seems to be a bias toward classifying an LLC interest as a security. In an amendment to the California Corporate Securities Law that was passed in connection with the California Act, the definition of "security" was expanded to include a reference to LLC interests. If the interest is a security then the offer and sale of the security must be registered under the Securities Act and under the blue-sky laws of each state in which an offer or sale is made. Thus it appears under the California statute, member-managed LLCs will not be eligible to use the cash method.

This issue has been addressed in several private letter rulings:

1. In PLR 9432018 all of the members were represented to be actively engaged in the business of managers, therefore it was held that the LLC met the active participation requirements.

2. In PLR 9321047, although the agreement provided for members to elect five managers as the management committee with authority to conduct business for the firm, it further provided that all members would be required to vote in order for the firm to take certain actions, including the election of members to the management committee and compensation committee; removal of a member from either committee; admission of a member or provisional member; dismissal of a member; amendment of the agreement; dissolution of the firm; major decisions; and approval of compensation committee recommendations subject to prescribed procedures. Based on the representation that the members would continue to engage in the practice of law and participate in the various described management activities, it was held that the LLC met the active participation requirements.

3. In PLR 9328005 an executive committee managed the LLC, but vote of all members was required for the LLC to take certain actions such as admit or expel a member; determine compensation of members; make expenditures in excess of a specified amount; borrow funds in excess of a specified amount; open or close a branch office; change the name of the LLC or the location of its principal office; sell or otherwise dispose of all or substantially all of the

assets of the LLC; dissolve the LLC; amend the agreement under which the LLC is operated. However, each member of the business did participate in handling client relations; supervising services provided to clients; billing, collecting, and negotiating fees; participating in business and practice development activities; staffing projects; including the selection and use of specialists; and supervising, training and evaluating LLC employees. Participation in these management activities was held to constitute active participation.

Syndicates that are considered tax shelters for this purpose include partnerships if over 35% of the losses of such entities during the taxable year are allocated to the limited partners or limited entrepreneurs. A limited entrepreneur is defined as one who does not actively participate in the management of such an enterprise. In the LLC, if the members are viewed as limited partners, then the limited partners are allocated all the LLC's losses which would mean that the LLC qualifies as a tax shelter. Thus, all LLCs with losses would be forced to use the accrual method.

If not classified as a limited partner, then the LLC member would probably be designated as a limited entrepreneur. If the LLC member does not participate in management and if more than 35% of the LLC losses are allocated to the limited entrepreneurs, then accrual basis accounting is required. Therefore, it seems that the only way that an LLC would not be a syndicate would be if it has no losses or at least 65% of any losses were allocated to persons who actively participate in management and are not limited partners or limited entrepreneurs.

Audit Procedures

There are three sets of rules for tax audits and adjustments for partners and partnerships:

(1) For partnerships with more than 100 partners and that so elect, the electing large partnership rules enacted in 1997 apply but, very few partnerships have made this election(see Taxpayer Relief Act of 1997);

(2) For partnerships with more than 10 partners or with pass-throughs as partners (and that are not electing large partnerships), the Tax Equity and Fiscal Responsibility Act (TEFRA) rules apply; *and*

Note: Under (1) & (2) above, partnership items generally are determined at the partnership level under unified procedures.

(3) For partnerships with 10 or fewer partners that have not elected the TEFRA audit rules, audit and adjustment rules applicable generally to taxpayers subject to the Federal income tax apply.

Thus, for a partnership with few partners that does not elect to be governed by TEFRA rules, the tax treatment of an adjustment to a partnership's items is determined for each partner in separate proceedings In the case of a partnership

with partners in different locations, this may result in separate judicial determinations in different courts that are potentially subject to different appellate jurisdiction.

Note: Prior to the 1982 enactment of TEFRA, these had been the rules for all adjustments with respect to partners, regardless of the number of partners in the partnership.

TEFRA Rules

TEFRA established unified rules. These rules require the tax treatment of all "partnership items" (as defined in the regulations) to be determined at the partnership, rather than the partner, level. Thus, the IRS may challenge the reporting position of a partnership by conducting a *single* administrative proceeding to resolve issues with respect to *all* partners.

Note: The TEFRA rules do not, however, change the process for collecting underpayments with respect to deficiencies at the partner (not the partnership) level, though a settlement agreement with respect to partnership items binds all parties to the settlement.

Tax Matters Partner (TMP)

The TEFRA rules establish the Tax Matters Partner (TMP) as the primary representative of a partnership in dealings with the IRS. The TMP is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no TMP is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the TMP.

Notice

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. For partnerships with more than 100 partners, however, the IRS generally is not required to give notice to any partner whose profits interest is less than one percent.

Additional Rules & Rights

Partners have the right to participate in administrative proceedings at the partnership level, and can request an administrative adjustment or a refund for the partner's own separate tax liability. To the extent that a settlement is reached with respect to partnership items, all partners are entitled to consistent treatment.

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partnership item for a partnership taxable year if more than three years have elapsed since the later of the filing of the partnership return, or the last day for the filing of the partnership return (without extensions).

Bipartisan Budget Act of 2015 Centralized System

Generally, for returns filed for partnership taxable years beginning after 2017, the Bipartisan Budget Act of 2015 *repeals* the TEFRA partnership audit and adjustment rules as well as, the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves applicable the present-law rules for deficiency proceedings.

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of a partnership, and any partner's distributive share thereof, generally are determined at the partnership level. Moreover, any tax attributable to these items generally is assessed and collected at the partnership level.

Conversion of Partnership to LLC

Generally, a partnership or a limited partnership can convert to an LLC without incurring any income tax if the members of the LLC continue to own their same ownership interest. The partnership could actually use one of several methods to convert tax-free to an LLC. These include:

(1) Contribution by all partners of their partnership interests to a newly formed LLC in exchange for corresponding membership interests in the LLC followed by partnership liquidation;

(2) Creation by the partners of an LLC followed by a merger of the partnership and the LLC in which the LLC is the surviving entity;

(3) Partnership liquidation and distribution of assets to partners who then contribute undivided interest to the LLC; *and*

(4) Partnership contribution of assets to the LLC followed by liquidation.

Upon conversion, the partnership must avoid termination in order for the transaction to be tax-free. A partnership terminates if 50% or more of the interest in its capital and profits are sold or exchanged within a 12-month period. Upon a termination for income tax purposes, the LLC's books are closed and it is deemed to distribute all of its assets to its members. Each of these persons is

then deemed to contribute its share of the former LLC's assets to a newly created LLC in exchange for a membership interest.

In R.R. 84-52, the Service ruled that a conversion of a general partnership into a limited partnership did not constitute a termination as long as each partner's total percentage interest in the partnership's profits, losses, and capital remained the same after the conversion and the business activity of the partnership continued. R.R. 84-52 has been applied in several private letter rulings to the conversion of a partnership into an LLC. In PLR 9029019 the IRS ruled that a general partnership that converted into an LLC did not terminate. In PLR 9010027, the same ruling was issued to a limited partnership that converted into an LLC (see also PLR 9321047).

Conversion of S Corporation to LLC

As a result of the repeal of the General Utilities doctrine by the Tax Reform Act of 1986, corporate liquidations now result in a tax at the entity level as well as a tax to the shareholder if the distribution is greater than the shareholder's basis in the stock of the corporation. The corporate liquidation provisions (§336) apply equally to the S corporation and result in double tax whether assets are contributed to the LLC and the LLC interest is distributed to the shareholders or the assets are distributed to the shareholders who then contribute them to the new entity. Relief from the double tax burden is afforded the S corporation shareholder to the extent that the gain recognized by the S corporation does increase the basis of the shareholder so that the gain recognized on the distribution to the shareholder is reduced accordingly. However, the LLC election may not be worthwhile for an existing S corporation with substantially appreciated assets that are subject to the built-in gains tax.

Conversion of C Corporation to LLC

A conversion of a corporation to an LLC can take place in one of several ways, however, both methods result in the same double tax as described above for the conversion of the S corporation, but there is no step up in the shareholder's basis as a result of the gain recognition at the corporate level. The methods include:

(1) Contribution by all stockholders of their shares to a newly formed LLC in exchange for corresponding membership interests in the LLC followed by liquidation of the corporation, *and*

(2) Creation by the stockholders of an LLC followed by a merger of the corporation and the LLC in which the LLC is the surviving entity.

Both of these methods will result in a corporate liquidation and related double tax and loss of tax attributes. In other words, any net operating loss carryforwards or similar tax attributes would be lost at the time of the corporate liquidation. This will oftentimes make it too expensive for a corporate entity to take advantage of the LLC form.

Local Taxes on Conversion

In general, there should not be any sales tax or risk of reassessment of real property values for property tax purposes as a result of a conversion to an LLC. However, these rules are complex and there are numerous exceptions. California's sales and property taxes are discussed here to illustrate how these taxes would be applied to an entity that converts to an LLC.

Sales & Use Tax

Conversion of a partnership to an LLC will not trigger the sales tax if the ownership of the acquiring corporation is comprised of 80% or more of the owners of the transferor and 80% of the assets are acquired (Calif. Revenue & Taxation §6006.5(b)). Therefore conversions of partnerships to LLCs should not trigger sales tax because the ownership interests on a conversion will remain largely the same as the predecessor.

The result for conversion of a corporation could be somewhat different because the corporation must formally dissolve/liquidate and then reincorporate. The surrender of a stock interest in a corporation in exchange for tangible personal property distributed in a liquidation or a partial liquidation is not generally taxable. The transaction is not a "sale" and the stock surrendered in consideration is not viewed as consideration (CSTCR 395.2260 & 395.2440).

An exception to the general rule that no sales tax arises on the liquidating distribution of a corporation appears to exist with respect to inventory and other property that has been purchased in an exempt purchase for resale by the corporation. Because the corporation does not sell the property in the ordinary course of business, a transfer of such property to shareholders as a liquidating dividend constitutes a taxable use of the property by the corporation. Therefore, a use tax is imposed on the transfer (CSTCR 395.2300).

Where a shareholder has loaned money to the corporation, liquidation distributions to the creditor-shareholder in satisfaction of corporate debt are taxable (CSTCR 395.1400). Such a transaction is viewed as a sale of assets with the consideration being the discharge of debt.

Example

Susan and Lucy own Curl Up and Dye a beauty shop organized as a C corporation. After several years of losses that are trapped in the C corporation, they decide to liquidate the C corporation and form an LLC. NOL carry-forwards will offset the gain at the corporate level recognized upon liquidation and so the double tax will be substantially reduced. Susan receives most of the tangible property in payment of a large loan that she had made to the corporation. The transfer is deemed made in satisfaction of the debt and the sales tax applies, using the book value of the tangible personal property held by the corporation as the sales price. Susan's debt should be repaid in cash.

Real Property Taxes

The transfer of real property out of the corporate entity or the partnership will subject the property to reassessment unless it qualifies under the exception set forth in California. Revenue & Taxation §62. This exception exempts the property from reassessment if the proportional interest remains the same as the proportional interest of stock/capital held in the corporation/partnership. In order for this exception to apply, the shareholder/partner must receive his or her proportional interest in each parcel of property owned by the dissolving corporation/partnership. This exception would generally be met if the partners/shareholders of a partnership/corporation converting to an LLC are merely converting their interests and after the conversion will retain their same economic percentage interest.

The effect of a conversion on existing real property title insurance is unclear. A title insurance company might take the position that its insurance coverage runs only to the corporation or partnership initially named in its policy and that it does not cover the LLC that emerges from a conversion. To avoid this uncertainty, a partnership or corporation that is converting to the LLC form would be well advised to obtain in advance an endorsement of its existing title insurance policy to ensure that the insurance coverage will not lapse because of the conversion.

Real Property Transfer Taxes

Most counties in California impose a Documentary Transfer Tax on transfers of real property. Most counties treat transfers to a partnership in exchange for partnership interests as consideration subject to transfer taxes. Clearly, if the partnership transferring the property is terminated, the partnership will be liable for the transfer tax. If the partnership is not terminated, then there should be no county or city transfer taxes on California real property as a result of the conversion. Under IRC 708(b)(2)(A) the merger of two or more partnerships will not

trigger a termination of the partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership (in this case the LLC). The result here is not entirely clear.

A corporation will be subject to real property transfer taxes and could run the risk of paying two reconveyance fees, once on the liquidation and once on the contribution of the property to the LLC. The corporation should deed the property to the LLC so that only one reconveyance fee will be assessed.

Entity Comparison

	Sole Proprietorship	Partnership	S Corporation	C Corporation
Who can own the company?	One individual owner	2 or more owners	Shareholders limited to 100 and can only be individuals, certain trusts, and estates	No limit, however, some states require a minimum of 2 shareholders
Who pays the Federal income tax?	Income and deductions are reported by individual on Schedule C (Form 1040). Separate Schedule C's are needed for each business	Partnership does not pay tax but files a Form 1065 as an information return. Partners are taxed on their distributive share of income and deduction as shown on their Form K-1.	If formerly a C corporation, there can be tax on built-in gains and passive investment income. Otherwise, an S corporation is not taxed but only files Form 1120S as an information return. Shareholders are taxed on income attributable to their stock ownership	Income is taxed twice. Once when earned by a C corporation and again when distributed to shareholders as a dividend. Corporation files Form 1120.
What is the maximum tax rate?	37% for the owner	Normally zero for the partnership and 37% for partners	Normally zero for the S corporation and 37% for shareholders	21% for the corporation and 37% for shareholders
What tax year can be used?	Same year as the individual owner	Restricted to tax year of majority partners, principal partners, or calendar year	With certain exceptions, must be calendar year unless IRS approves different year for business purposes	Calendar year or any fiscal year based on filing of the first tax return
When is the income taxable?	Same year as the individual owner	Partners must report their share of partnership income in the year in which the partnership's tax year ends	Shareholders must report their share of corporate income in the year in which the corporation's tax year ends. However,	Based on corporation's taxable year. Corporation is subject to estimated taxes. Shareholders pay tax on dividends in

			shareholders and corporation can be subject to estimated taxes	the tax year received
How is income allocated to owners?	All to individual owner	According to the partnership agreement, which normally allocates based on profit and loss percentage.	Pro-rata based on share ownership determined on a daily basis, according to the number of shares held on each day of the corporation's tax year	All to corporation
What happens when you contribute property to the company?	Nothing - the owner and the company are one and the same	Not a taxable event, unless the property is mortgaged in excess of basis (§721)	Taxable unless terms of §351 are met	Taxable unless terms of §351 are met
What is the character of the income when received by the owners?	Income retains its characteristics	Income retains its characteristics	Income retains its characteristics	All income characteristics are lost on distribution of income to shareholders
How are net operating losses allocated?	All to individual owner	According to the partnership agreement, which normally allocates based on profit and loss percentage	Pro-rata based on share ownership determined on a daily basis, according to the number of shares held on each day of the corporation's tax year	All to corporation
How much loss can the owner deduct?	Capital investment plus debt	Partner's capital investment plus a share of partnership debt	Shareholder's capital investment plus shareholder loans to corporation	Owner is corporation. Shareholders are not entitled to deductions
Do the "at-risk" rules apply?	Yes, but individual has an indefinite carryover of excess losses	Yes, but partners have an indefinite carryover of excess losses	Yes, but shareholders have an indefinite carryover of excess losses	Yes, if closely held, but corporation has an indefinite carryover of excess losses
Do the passive loss rules apply?	Yes	Yes	Yes	Yes, for closely held and personal service corporations
What happens if earnings are retained?	Taxed to the individual owner	Taxed to the partners, but increases basis in partnership interest	Taxed to the shareholders, but increases stock basis	Taxed to corporation and subject to accumulated earnings tax penalty

Are nonliquidating distributions taxable to owners?	No	No, unless money distributed exceeds partner's basis. Section 751 assets can cause gain to be ordinary	No, unless distribution exceeds shareholder's stock basis or AAA. Accumulated earnings and profits can cause dividend treatment	Yes, to extent of earnings and profits or if distribution exceeds stock basis
Is the distribution of appreciated property taxable to the company?	No	No	Yes, but recognized gain is passed through to shareholders	Yes
What can be done to split income among family members?	Employ children	Employ children; gift or sell partnership interests subject to certain limitations and "kiddie backfire" tax	Employ children; gift or sell stock but watch out for "kiddie backfire" tax. Adjustment can be required to adequately reflect compensation for services	Employ children; gift or sell stock but watch out for "kiddie backfire" tax
How are organizational expenses reported?	Amortized over 180 months	Amortized over 180 months	Amortized over 180 months	Amortized over 180 months
How is capital gain taxed?	To the individual owner at maximum 28% rate	Passes through and is taxed to partners	Except for certain penalty taxes, it passes through and is taxed to shareholders	To corporation using regular corporate tax rates
How are capital losses reported?	Owner can annually use $3,000 of capital losses against ordinary income. Balance is indefinitely carried over	Pro-rata by partners	Pro-rata by shareholders	Deductible by the corporation but only to the extent of capital gain. Balance can be carried back 3 years and forward 5 years
How are §1231 gains and losses reported?	Owner is taxed on gains and can deduct losses subject to 5-year lookback rule on losses	Pro-rata by partners	Pro-rata by shareholders	Corporation is taxed on gains and can deduct losses subject to 5-year lookback rule on losses
How is the alternative minimum tax reported?	Taxed to the individual owner at a 26% to 28% rate	Pro-rata by partners	Pro-rata by shareholders	Taxed to the corporation at a 20% rate and subject to the ACE adjustment
Is §1244 treat-	No	No	Yes	Yes

ment available?				
Is there a potential built-in gains tax?	No	No, unless partner contributed property with a basis different than its FMV in which case the built-in gain or loss will be allocated to the contributing partner under §704(c)	Yes, if formerly a C corporation. However, built-in gain or loss on contributed property is not allocated to the contributing shareholder but pro-rata to all shareholders	No, unless later converted to an S corporation. Built-in gain or loss on contributed property is not allocated to the contributing shareholder.
Are special allocations permitted?	No	Yes, if they have substantial economic effect	No	No
Do company liabilities increase the owner's basis?	Yes	Yes, they increase the partner's basis in his or her partnership interest.	No	No
Are fringe benefits widely available?	No	No	No, especially for 2% or greater shareholder	Yes

All Industries

SUBCHAPTER K ANTIABUSE RULE SUMMARIZED

Publication Date: June 26, 1995

Section 701 — Partners Subject To Tax

Summary

The Service has issued a coordinated issue paper on reg. section 1.701-2, the partnership anti-abuse rule. The ISP paper summarizes the final regulation, which was issued in December 1994. (For the full text of T.D. 8588, see 94 TNT 255-1 or H&D, Dec. 30, 1994, p. 1994.)

Drawing on the language of the regulation, the paper describes the "intent of subchapter K," facts and circumstances that may indicate an abusive partnership, and the Service's authority to recast transactions to achieve tax results consistent with the intent of subchapter K. The paper also states that, as noted in Announcement 94-87, 1984-27 IRB 124, 94 TNT 114-8, the anti-abuse rule will be administered through the industry specialization program. Examiners are directed to contact the partnership industry or issue specialist when a reg. section 1.701-2 issue is considered.

Full Text

Effective date — June 19, 1995

PARTNERSHIP INDUSTRY COORDINATED ISSUE SUBCHAPTER K ANTI-ABUSE RULE REGULATION section 1.701-2

ISSUE

Under what circumstances is the Commissioner of the Internal Revenue authorized under section 1.701-2 to recast a transaction involving the use of a partnership?

What procedure must Examination personnel follow if it is determined during the course of an examination that the application of section 1.701-2 may be appropriate?

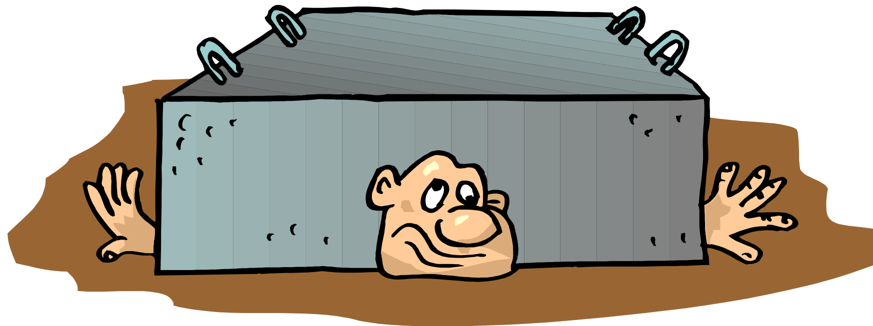
FACTS AND LAW

Final regulation section 1.701-2, 1995-7 I.R.B. 5, was issued on December 29, 1994. That regulation, along with Announcement 94-78, 1994-27 I.R.B. 124, provide the basis for this paper.

Subchapter K was enacted to permit businesses organized for joint profit to be conducted with "simplicity, flexibility, and equity as between the partners." S. Reg. No. 1622, 83d Cong., 2d Sess. 89 (1954); H.R. Rep. No 1337, 83d Cong., 2d Sess. 65 (1954).

Partnership Anti-Abuse Regulations

Reg. §1.701-2(a)



- The IRS may recast a transaction involving a partnership even though it complies with the Code
- Possible consequences include:
  - disregard of the partnership
  - denying a taxpayer partner status
  - adjustments to accounting method
  - reallocation of partnership items
  - denying the entity partnership status
- These regulations may be applied when a partnership is used to reduce tax liability in a manner inconsistent with Subchapter K

It was not intended, however, that the provisions of Subchapter K be used for tax avoidance purposes. For example, in enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if such concepts are more appropriate in applying other provisions of the Code. H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

Similarly, in later amending the rules relating to special allocation, Congress sought to "prevent the use of special allocations for tax avoidance purposes, while allowing their use for bona fide business purposes." S. Rep. No. 938, 94th Cong., 2d Sess. 100 (1976).

On May 12, 1994, the IRS and Treasury issued a notice of proposed rule making (59 FR 25581) under section 701 of the Code. That document proposed to add an anti-abuse rule under subchapter K. On December 29, 1994, the regulation was finalized. The regulation is expected to affect a relatively small number of partnership transactions that make inappropriate use of the rules of Subchapter K. It is not intended to interfere with bona fide joint business arrangements conducted through partnerships.

Application of Subchapter K Rules

As set forth in section 1.701-2(b), the provisions of Subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of Subchapter K. Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partner's aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

Intent of Subchapter K

Section 1.701-2(a) describes the intent of subchapter K. Generally, 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 in the intent of Subchapter K are the following requirements:

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) 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 partner's income (collectively, proper reflection of income).

Exception — Certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (a)(2) to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. Examples of such provisions include section 732, the elective feature of section 754, and the value-equals-basis rule in section 1.704- 1(b)(2)(iii)(c), as well as regulatory de minimis rules such as those reflected in sections 1.704-3(e)(1) and 1.752-2(e)(4). In determining whether a transaction clearly reflects the partners' income, the principles of sections 446(b) and 482 apply.

Facts and Circumstances

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 is determined 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 factors set forth below may be indicative, but do not necessarily establish that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified below or otherwise) depends on all the facts and circumstances. The presence or absence of any factor described in this paragraph does not create a presumption that a partnership was, or was not, used in such a manner. Factors include:

(1) 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;

(2) 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 are 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 results and whose interest in the partnership was liquidated or disposed

of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) 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;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of 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 (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) 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 related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or related party).

Recast Transactions

If it is determined that a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the transaction is recast as appropriate to achieve tax results that are consistent with the intent of subchapter K. Even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of Subchapter K:

(1) 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;

(2) One or more of the purported partners of the partnership should not be treated as a partner;

(3) The methods of accounting used by the partnership or partners should be adjusted to reflect clearly the partnership's or the partner's income;

(4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should otherwise be adjusted or modified.

Abuse of Entity Treatment

Section 1.701-2 also provides a rule for abuse of entity treatment. Under section 1.701-2(e), a partnership is treated 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 unless a provision of the Code or regulations, prescribes the treatment of the partnership as an entity (in whole or in part) and that treatment and the ultimate tax results — taking into account all the facts and circumstances, are clearly contemplated by that provision. The Commissioner's authority to treat a partnership as an aggregate of its partners is not dependent on the taxpayer's intent in structuring the transaction. Underlying the promulgation of paragraph (e) is the belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of subchapter K to transactions involving partnerships.

Scope and Application

Section 1.701-2 applies solely with respect to taxes under subtitle A of the Code (generally, income taxes). Any reference to a tax in section 1.701-2 is limited to a tax imposed under Subtitle A. Therefore, examples 5 and 6 in the regulation as originally finalized have been deleted. No inference is intended as to the treatment under current law of transactions not covered by the regulation.

Effective Date

Section 1.701-2 generally applies for all transactions involving a partnership that occur on or after May 12, 1994, except that the rule for abuse of entity treatment, paragraph (e), applies for transactions on or after December 29, 1994. Paragraph (i) clarifies that the Commissioner can continue to assert and to rely upon applicable nonstatutory principles and other statutory authorities to challenge transactions. If a transaction occurred prior to the effective date, consider whether it conforms to established legal doctrines such as the business purpose and substance over form doctrines, including the step transaction and sham transaction doctrines.

Announcement 94-87

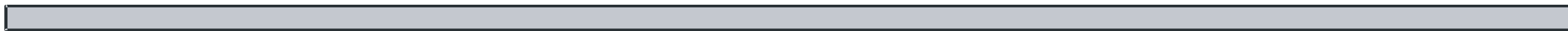
Many comments in response to the proposed regulation expressed concerns that once finalized, Examination personnel would be unable to apply the provisions uniformly. Announcement 94-87, 1994-27 I.R.B. 124, advised taxpayers that when an issue that may be affected by the regulation is considered on examination, any application of the regulation must be coordinated with both the Issue Specialist on the Partnership.

Industry Specialization Program team and the National Office. This coordination will result in fair and consistent treatment of taxpayers in the application of the regulation to partnership transactions. Therefore, if an examiner determines that section 1.701-2 may apply, the examiner must contact the Partnership Industry or Issue Specialist. It will be the responsibility of the specialist to coordinate with the National Office.

SUMMARY

Under certain circumstances, the Commissioner of Internal Revenue is authorized to recast transactions involving the use of partnerships that are inconsistent with the intent of Subchapter K.

Examiners should be aware that when an issue is considered under section 1.701-2, the Partnership Industry or Issue Specialist must be contacted. The Partnership Industry or Issue Specialist will coordinate application of the regulation with the National Office.



Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

115. Although there are benefits of professional firms operating as an LLC, a professional receives no protection from liability for:
   a. loans for working capital.
   b. liabilities of the business.
   c. their own acts.
   d. lease obligations.

116. How does an LLC provide an attractive alternative to a limited partnership for charities engaged in fund-raising ventures?
   a. by avoiding limited liability on long-term lease obligations.
   b. by creating fiduciary obligations.
   c. by providing necessary control but meeting the requirements of §501(c).
   d. by limiting liability on working capital loans.

117. What is one of the required conditions under proposed regulations to exclude a member's share of the LLC's income and loss from net earnings from self-employment?
   a. The LLC's controlling documents fail to designate a manager.
   b. The LLC statute does not elect managers.
   c. The LLC member is not a manager.
   d. The LLC member serves as an investor.

118. For tax reporting purposes, four types of taxpayers are required to use the accrual method of accounting. While LLCs are excluded from the list by name, their substance may require them to use the accrual method of accounting. When may an LLC use the cash method of accounting?

a. The members of the LLC are allocated all the entity's losses.

b. The members of the LLC are characterized as limited entrepreneurs.

c. The nonparticipating members of the LLC are allocated more than 35% of the losses.

d. The members of the LLC are allocated no losses.

119. Existing entities can convert to limited liability companies. However, which entity will generally find the expense of conversion greater than the benefits of the LLC?

a. a C corporation.

b. an S corporation.

c. a partnership.

d. a limited partnership.

120. Converting an existing entity to an LLC may trigger local taxes. For example, in California, which of the following circumstances would result in taxation?

a. a conversion of a C corporation to an LLC where a stock interest is surrendered in exchange for liquidation distributions of tangible personal property.

b. a conversion of a C corporation to an LLC where liquidation distributions are made to a creditor-shareholder in fulfillment of corporate debt.

c. a conversion of a partnership to an LLC where a transfer of real property is made by a partnership that does not terminate.

d. a conversion of a partnership to an LLC where the LLC is comprised of at least 80% of the partnership's owners and it acquires at least 80% of the assets.

Answers & Explanations

1. For tax purposes, a partnership is essentially a flow-through entity. As a result, a partner's income is reported and taxed on:

   a. Correct. Partnership income flows through and is reported and taxed on a partner's Form 1040.

   b. Incorrect. Under §701 through §761, the partnership files an information return, Form 1065, for its operations. However, a partnership does not pay taxes on its income, rather income and deductions are passed through to the individual partners for reporting on Form 1040.

   c. Incorrect. Form 1120, Corporate Income Tax Return, is used for a corporation's tax reporting, not a partner's taxes.

   d. Incorrect. Under the "check-the-box" regulations, an eligible entity's election of its classification may be made on Form 8832, Entity Classification Election. Form 8832 is not an income tax reporting form. [Chp. 1]

2. A variety of businesses can be treated as a partnership. Which of the following relationships is most often considered a partnership for tax purposes?

   a. Incorrect. For income tax purposes, a trust cannot be classified as a partnership.

   b. Incorrect. A corporation cannot be classified as a partnership for income tax purposes.

   c. Correct. A joint undertaking that is created to carry out a business venture meets the definition of a partnership.

   d. Incorrect. A co-tenancy or joint undertaking merely to share expenses is not a partnership. [Chp. 1]

3. How can a limited partnership address the unlimited liability issue of the general partner?

   a. Incorrect. A limited partnership with a corporation as a sole general partner is recognized as a partnership if, among other things, the limited partners do not own over 20% of the corporate general partner's stock.

   b. Incorrect. A limited partnership with a corporation as a sole general partner is recognized as a partnership if, among other things, the net worth of the corporate general partner at all times is at least 15 percent of that total contribution or $250,000, whichever is less.

   c. Correct. Limited partnerships can resolve the unlimited liability problem by making the general partner a corporation since corporations have limited liability.

d. Incorrect. Having a limited partner actively manage the limited partnership may result in the limited partner being classified as a general partner, which would mean that the limited partner loses the benefit of limited liability. The unlimited liability issue of a general partner would still remain. [Chp. 1]

4. The Internal Revenue Service has mixed reactions to partnerships that have a corporation as a partner. Initially, the IRS challenged the taxation of limited partnerships with corporate general partners:

a. Incorrect. In R.R. 79-106, the IRS essentially conceded the decision in Larson.

b. Incorrect. In *Larson v. Commissioner,* 66 T.C. 159, the courts rejected the IRS's claim, holding that corporate characteristics did not outnumber partnership characteristics.

c. Incorrect. In *Zuckman v. United States,* 524 F.2d 729 (Ct. Cl. 1975), the courts rejected the IRS's claim, holding that corporate characteristics did not outnumber partnership characteristics.

d. Correct. Initially, the IRS attempted to tax limited partnerships with corporate general partners as corporations under the Morrissey regulations claiming that there were more corporate characteristics than partnership characteristics. [Chp. 1]

5. In a Tax Court's analysis of whether a business is a corporation or a partnership, what characteristic is present if the limited partners possess substantially all the ownership interest in the partnership?

a. Correct. Centralized management exists if the limited partners have substantially all the proprietary interest in the partnership. There is decentralized management if the general partner has a significant proprietary interest.

b. Incorrect. Continuity refers to whether an organization has continuity of life and does not relate to whether limited partners possess substantially all the proprietary interest in the partnership.

c. Incorrect. Free transferability does not relate to whether limited partners possess substantially all the proprietary interest in the partnership.

d. Incorrect. The type of liability, personal liability, does not refer to whether limited partners possess substantially all the proprietary interest in the partnership [Chp. 1]

6. The Larson case, 66 T.C. 159, involved a decision analyzing the IRS's business characteristics test. In Larson, the Tax Court determined that the partnership or its partners had:

a. Incorrect. In *Larson,* the Tax Court determined that the partnership did not have continuity of life because the partnership would dissolve if the corporate general partner were to file bankruptcy.

b. Incorrect. In *Larson*, the Tax Court determined that the partnership had centralized management. The interest of the general partner had no substantial proprietary interest.

c. Correct. In *Larson*, the Tax Court determined that the limited partners had free transferability of their interest. The limited partners could transfer their interest only with the consent of the general partner, but the Tax Court did not find that to be a substantial limitation.

d. Incorrect. In *Larson*, the Tax Court determined that the partnership did not have limited liability. Because the general partner was not a "dummy," it was found to have personal liability. [Chp. 1]

7. Which IRS revenue procedure reflects the requirements that must be met in order to obtain the favorable benefits of a limited partnership?

a. Correct. R.P. 72-13 provides requirements that must be fulfilled in order for the taxpayers to get the tax benefits of the limited partnership form. R.P. 72-13 provides three requirements that must be met for the limited partnership with a corporation as a sole general partner to be recognized as a partnership.

b. Incorrect. R.P. 74-17 provides additional requirements imposed on the limited partnership with a sole corporate general partner in requesting an advance ruling.

c. Incorrect. In R.P. 87-3, the IRS states that it will not issue advance rulings or determination letters regarding special allocation arrangements.

d. Incorrect. R.P. 94-46 provides additional requirements imposed on the limited partnership with a sole corporate general partner in requesting an advance ruling. [Chp. 1]

8. Which IRS revenue procedure specifies a checklist of information required with advance ruling requests related to limited partnerships?

a. Correct. R.P. 75-16 provides a checklist of information required with advance ruling requests to assure that a limited partnership is recognized for tax purposes.

b. Incorrect. R.P. 87-32 has provisions for using "expeditious approval" to request retention of, or a change to, a tax year that is a natural business year.

c. Incorrect. R.P. 89-12 provides additional requirements imposed on the limited partnership with a sole corporate general partner in requesting an advance ruling.

d. Incorrect. R.P. 91-13 also provides additional requirements imposed on the limited partnership with a sole corporate general partner in requesting an advance ruling. [Chp. 1]

9. Which of the following is an additional representation required in order for a tax shelter to obtain a favorable limited partnership ruling?

   a. Correct. The IRS requires that creditors making nonrecourse loans to the tax-sheltered partnership must not have or acquire any interest as a partner.

   b. Incorrect. None of the additionally required representations relates to whether a husband-wife partnership is involved.

   c. Incorrect. The IRS requires that losses from operation of a partnership during the first two years will not exceed the amount of equity capital invested in the partnership.

   d. Incorrect. The IRS requires that the general partners must have an interest equal to at least one percent of each item of partnership income or deduction. [Chp. 1]

10. The check-the-box regulations:

   a. Correct. The check-the-box regulations allow an entity that is not required to be classified as a corporation to elect to be taxed as either a partnership or a corporation.

   b. Incorrect. These regulations have default classifications for eligible entities. The default classifications provide many entities with the classification they would have chosen. Thus, an election will need to be filed only when the default classification is different from the classification the entity chooses.

   c. Incorrect. The Treasury abandoned a four-factor test and substituted the check-the-box system.

   d. Incorrect. The check-the-box regulations replaced the Kintner regulations, which were fact-intensive classification regulations based on the historical differences between partnerships and corporations under local law. [Chp. 1]

11. Notice 97-1 and TD 8697 specify entities that are classified as corporations. Which entity can be classified as a corporation or can be disregarded as an entity separate from its owner?

   a. Incorrect. The regulations specify an insurance company is classified as a corporation.

   b. Incorrect. State-owned organizations are classified as corporations under the final regulations.

   c. Correct. A single member entity can be classified as a corporation or can be disregarded as an entity separate from its owner.

   d. Incorrect. An eligible entity with two or more members can be classified as either a partnership or a corporation. [Chp. 1]

12. Under the check-the-box regulations, a foreign entity with no requirement to be treated as a corporation:

a. Incorrect. Regulations adopt a passthrough default for domestic entities, not foreign entities.

b. Incorrect. A foreign entity's default classification depends on whether members of the entity have limited liability.

c. Incorrect. Foreign entities and domestic entities are treated differently under these regulations.

d. Correct. The regulations contain a list of foreign entities that are treated as per se corporations. However, any entity that is not required by the regulations to be treated as a corporation is an eligible entity and may choose its classification. [Chp. 1]

13. Which situation will result in double taxation of an investment club?

a. Correct. Double taxation of investment clubs will apply together with other corporate tax provisions if association status is established.

b. Incorrect. Members of investment clubs usually pledge regular monthly amounts. This action does not determine the tax status of the club.

c. Incorrect. Partners are separately taxed on their distributive shares of the club's investment income if partnership status is established.

d. Incorrect. An investment club is generally formed when individuals form a group and pool stated funds for an investment in securities. This action alone does not determine the tax status of the club. [Chp. 1]

14. What is the result when a partnership agreement allocation fails to have substantial economic effect?

a. Incorrect. Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date does not include any extensions of time.

b. Incorrect. One of the features of an allocation that has substantial economic effect is that the partner receiving the allocation also receives its economic benefit or bears its burden.

c. Incorrect. An allocation that does not have substantial economic effect is not a consideration in whether a partner is a limited or general partner.

d. Correct. The partner's distributive share of income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership if the allocation does not have substantial economic effect. [Chp. 1]

15. When a family member is gifted an interest resulting in ownership, dominion and control in a family manufacturing partnership the:

a. Incorrect. A family member is not required to be 18 years old to participate in a family partnership. However, due to the concern that abuses may

arise from the close association of partners if the partner is a child under age 18 of a parent-partner, a substantial portion of the child's distributive income share may be taxed at the parents' tax rate.

b. Correct. A family member will be recognized as a partner when: capital is a material income-producing factor and the family member's capital interest is obtained, including by gift, in which ownership, dominion, and control are received. Capital is a material income-producing factor in a manufacturing business.

c. Incorrect. In a publicly traded partnership, the interests are traded on an established securities market or the substantial equivalent. Family partnerships can be publicly traded partnerships, but the material income-producing factor is considered when determining whether the family member is a partner for tax purposes.

d. Incorrect. When capital is a "material income-producing factor" in the business, the partnership will be recognized for tax purposes, even if the various interests were created by gift. [Chp. 1]

16. Under §704(e), who is excluded from the list of eligible family members for family partnership purposes?

a. Incorrect. Under §704(e), ancestors are considered to be family.

b. Incorrect. Under §704(e), lineal descendants are considered to be family.

c. Correct. Under §704(e), siblings are not considered to be family.

d. Incorrect. Under §704(e), spouses are considered to be family. [Chp. 1]

17. A capital interest may be gifted to a family member in a family partnership in which capital is a material income-producing factor. Under §704(e), what is required when a capital interest is gifted to a family member?

a. Correct. When a capital interest is gifted to a family member in a family partnership in which capital is a material income-producing factor, an amount of income that represents reasonable compensation for services to the partnership must be allocated to the donor.

b. Incorrect. Under §704(e), when a capital interest is gifted to a family member in a family partnership in which capital is a material income-producing factor, the donor must receive reasonable compensation or services from the partnership.

c. Incorrect. When a capital interest is gifted to a family member in a family partnership, the donor may not retain control over the gifted interests, control must reside with the donee under Reg. §1.704-1(e)(2) guidelines.

d. Incorrect. When a capital interest is gifted to a family member in a family partnership in which capital is a material income-producing factor, the income allocated to the donee may not be proportionally greater than the income allocated to the capital interest of the donor. [Chp. 1]

18. A material income-producing factor exists when a significant amount of partnership income results from:

a. Incorrect. Capital is not considered to be a material income-producing factor if the income of the business consists principally of commissions.

b. Incorrect. Capital is not considered to be a material income-producing factor if the income of the business consists principally of compensation for personal services performed by members of the partnership.

c. Incorrect. Capital is not considered to be a material income-producing factor if the income of the business consists principally of fees.

d. Correct. Capital is considered to be a material income-producing factor if a substantial portion of the partnership's gross income results from the use of capital, such as substantial inventories. [Chp. 1]

19. Which business lacks material income producing capital?

a. Incorrect. Capital is a material income-producing factor in a business such as a drugstore that sells goods.

b. Incorrect. Some service businesses such as a dry cleaning business have sufficient investment in assets. Thus, capital is considered to be material.

c. Incorrect. Capital is a material income-producing factor in a business such as a precision machine shop that makes and sells goods.

d. Correct. Capital is not material in a pure service business such as a real estate brokerage firm. [Chp. 1]

20. What is one advantage of a partnership?

a. Incorrect. A disadvantage of partnerships is that the liability of general partners is not limited. General partners are joint and severally liable.

b. Correct. An advantage of partnerships is that losses and credits generally pass through to partners.

c. Incorrect. A disadvantage of partnerships is that partners typically cannot exclude certain tax-favored fringe benefits from their taxable income.

d. Incorrect. A disadvantage of partnerships is that partners may be required to file numerous state individual income tax returns for a multistate partnership business. [Chp. 1]

21. What is one disadvantage of a partnership?

a. Incorrect. An advantage of a partnership is that distributed income is not subject to double taxation.

b. Incorrect. An advantage of a partnership is that income is taxed to the partners, not the partnership.

c. Correct. A disadvantage of a partnership is that earnings will be taxed currently even if they are not distributed.

d. Incorrect. An advantage of a partnership is that there may be more than one class of partnership interests. [Chp. 1]

22. Which of the following must be filed for a partnership to elect complete exclusion from partnership treatment for tax purposes?

a. Correct. To choose complete exclusion, the partnership must file a partnership return, Form 1065, for the first year it wishes to be excluded from partnership treatment.

b. Incorrect. Form 1128, Application for Change in Accounting Period, is not used for a partnership to request exclusion from partnership treatment for tax purposes.

c. Incorrect. Form 7004, Application for Automatic Extension of Time To File Return for U.S. Partnership or for Certain Trusts, is not used for a partnership to request exclusion from partnership treatment for tax purposes.

d. Incorrect. Form 8082, Notice of Inconsistent Treatment or Amended Return, is not used for a partnership to request exclusion from partnership treatment for tax purposes. [Chp. 1]

23. An entity's request to the IRS for partial exclusion from partnership treatment for tax purposes:

a. Incorrect. The request for partial exclusion must state that the organization qualifies as an investing or operating agreement partnership under Reg. §1.761-2(a).

b. Incorrect. The request for partial exclusion must be submitted no later than 90 days after the beginning of the first tax year for which partial exclusion is chosen.

c. Correct. When choosing partial exclusion from partnership treatment, an organization must submit to the IRS a request that specifies the provisions from which exclusion is sought.

d. Incorrect. The Commissioner must approve the partial exclusion for it to be effective. Also, the exclusion is subject to any conditions the Commissioner may impose. [Chp. 1]

24. What are partners' partnership distributive shares based on?

a. Incorrect. Partnership distributive shares are based on the partnership agreement, not examination procedures.

b. Incorrect. The Tax Code provides numerous provisions for the taxation of partnerships; however, the regulations are not the basis of the distributive shares.

c. Incorrect. Partnership distributive shares are based on the partnership agreement, not IRS revenue rulings.

d. Correct. Partnership income and deductions are allocated among the partners according to their partnership distributive shares as determined by the partnership agreement. [Chp. 2]

25. Under IRS amendments, REG-209824-96, who is considered a general partner?

a. Incorrect. A partner will be treated as a limited partner if he or she does not have the authority to contract on behalf of the partnership.

b. Incorrect. A partner will be treated as a limited partner if he or she does not materially participate in a nonservice business or trade. The IRS regulations specify an individual will be classified as a general partner if the participation level is more than 500 hours during the tax year

c. Correct. When substantially all of the activities of a partnership involve the performance of services, such as a consulting business, any individual who provides consulting services will be considered a general partner.

d. Incorrect. A partner with limited liability for the debts or claims against the partnership will be considered a limited partner. [Chp. 2]

26. Under REG-209824-96, when may an individual exclude a portion of their distributive share from net earnings from self-employment?

a. Incorrect. Under REG-209824-96, whether a partner can freely transfer interests of the entity is not a factor in whether a general partner is allowed to exclude from net earnings from self-employment a portion of that individual's distributive share.

b. Incorrect. By definition, a limited partner has limited liability for the debts of or claims against the partnership by reason of being a partner. Limited partners are not subject to self-employment tax on their distributive share, whereas general partners are subject to the tax.

c. Correct. REG-209824-96 allows an individual who is not a limited partner for §1402(a)(13) purposes to exclude from net earnings from self-employment a portion of his or her distributive share if the partner holds more than one class of interest in the partnership.

d. Incorrect. By definition, a general partner is a partner who materially participates in the trade or business. Other conditions must be met for the general partner to be able to exclude from net earnings from self-employment a portion of his or her distributive share. [Chp. 2]

27. Under REG-209824-96, a partner participating in a partnership's business is allowed to bifurcate his or her distributive share:

a. Correct. An individual who participates in the trade or business of the partnership may bifurcate his or her distributive share by disregarding guaranteed payments for services rendered.

b. Incorrect. The bifurcation of interests of an individual who participates in the trade or business of the partnership is permitted only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners.

c. Incorrect. The bifurcation of interests of an individual who participates in the trade or business of the partnership is permitted only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners.

d. Incorrect. Limiting participation in the business to less than 100 hours is not required in order to bifurcate a distributive share. [Chp. 2]

28. In some cases, partnerships may be treated as a separate entity. When may a partnership choose to be treated as an aggregate?

a. Correct. A partnership may choose to be treated as an aggregate, rather than an entity, for administrative purposes if it has ten or fewer partners who are individuals.

b. Incorrect. A partnership is treated as a separate entity for audits and judicial review.

c. Incorrect. For purposes of making elections, a partnership is treated as a separate entity.

d. Incorrect. For purposes of making elections, regardless of the number of partners, a partnership is treated as a separate entity. [Chp. 2]

29. A partner's distributive share of partnership income is taxed when:

a. Incorrect. Distributive shares of partnership income are taxed regardless of whether the partner actually received the distributive share.

b. Incorrect. A partner is taxed on his or her distributive share of partnership income regardless of whether he or she received it or was aware of its existence.

c. Incorrect. Distributive shares of partnership income are taxed when earned, time of distribution is immaterial.

d. Correct. Distributive shares of partnership income are taxed when earned. [Chp. 2]

30. What amount of a partner's meal expense is generally deductible?

a. Incorrect. Meal expenses paid or incurred by the partnership for a partner are generally 50% deductible.

b. Correct. Generally, a partner can deduct 50% of meal expenses paid or incurred by the partnership for a partner.

c. Incorrect. Meal expenses paid or incurred by the partnership for a partner are generally 50% deductible.

d. Incorrect. Meal expenses paid or incurred by the partnership for a partner are generally 50% deductible. [Chp. 2]

31. If a partner handles a deduction differently on his or her individual tax return compared to the partnership's treatment of the deduction the:

a. Incorrect. Items of partnership income or deduction have the same character in the partner's hands, as they would have if the partner had realized

them directly rather than through the partnership. If a partner treats an item differently on his or her individual return, the IRS can automatically assess and collect any deficiency and penalties that result from adjusting the item to make its treatment consistent with the treatment on the partnership return.

b. Incorrect. The IRS can automatically assess penalties and collect any deficiency that result from adjusting the item to make its treatment consistent with the treatment on the partnership return.

c. Incorrect. Under §702(b), items of partnership income or deduction have the same character in the partner's hands, as they would have if the partner had realized them directly rather than through the partnership.

d. Correct. If a partner files Form 8082, Notice of Inconsistent Treatment or Amended Return, with his or her return identifying the different treatment, penalties for making adjustments to the return will not be assessed. [Chp. 2]

32. Based on *Falconer v. Commissioner*, what is a consequence of having no outside basis in a year in which the partnership incurs a loss?

a. Incorrect. A partner's distributive share of the partnership loss is allowed only to the extent of the adjusted basis, before reduction by the current year's losses, of the partnership's tax year in which the loss occurred. Any share of loss in excess of the partner's adjusted basis is not allowed for that year.

b. Incorrect. If a partnership loss is not deductible because it exceeds a partner's outside basis, the partner is allowed to deduct the loss in a later year only when his or her outside basis is greater than zero.

c. Correct. When a partner has no outside basis, he or she cannot deduct his or her portion of partnership losses.

d. Incorrect. A partner's distributive share of income plus their share of tax-exempt income increase outside basis. [Chp. 2]

33. Which of the following statements is correct regarding the treatment of fees incurred for the marketing of a partnership interest?

a. Incorrect. Neither the partnership nor any partner is allowed a deduction for amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

b. Incorrect. Neither the partnership nor any partner is allowed a deduction for amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

c. Incorrect. Neither the partnership nor any partner is allowed a deduction for amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

d. Correct. Neither the partnership nor any partner is allowed a deduction for amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership [Chp. 2]

34. Under §709 what is the minimum period certain organization fees may be amortized over?

a. Incorrect. The partnership can choose to amortize certain organization fees over a period of not less than 180 months.

b. Incorrect. The partnership can choose to amortize certain organization fees over a period of not less than 180 months.

c. Correct. The partnership can choose to amortize certain organization fees over a period of not less than 180 months.

d. Incorrect. The partnership can choose to amortize certain organization fees over a period of not less than 180 months. [Chp. 2]

35. Under §195, a partnership may elect to amortize start-up expenses. What must the partnership do to make this election?

a. Correct. To make an election to amortize start-up expenses, a statement related to the start-up expenses must be attached to the partnership return for the tax year in which the amortization period begins.

b. Incorrect. A statement related to the start-up expenses, not the partnership agreement, must be attached to the partnership return to make the election.

c. Incorrect. A statement related to the start-up expenses must be attached to the partnership return, Form 1065, to make the election.

d. Incorrect. A statement related to the start-up expenses must be attached to the partnership return, Form 1065, to make the election. [Chp. 2]

36. Under the American Jobs Creation Act of 2004:

a. Correct. Under the American Jobs Creation Act of 2004, a taxpayer is currently allowed to elect to deduct up to $5,000 of start-up expenditures in the taxable year in which the trade or business begins.

b. Incorrect. Under the American Jobs Creation Act of 2004, a taxpayer may elect to deduct up to $5,000 of organizational expenditures in the taxable year in which the trade or business begins.

c. Incorrect. Under the American Jobs Creation Act of 2004, the deductible amounts for start-up and organizational expenditures are reduced (but not below zero) by the amount that the cumulative cost of start-up or organizational expenditures exceeds $50,000, respectively.

d. Incorrect. Under the American Jobs Creation Act of 2004, start-up and organizational expenditures that are not deductible in the year in which the trade or business begins are amortized over a 15-year period. [Chp. 2]

37. Which of the following is a requirement of a partnership information return?

a. Incorrect. The return showing income, deductions, and other information required must be filed by the partnership, not each partner.

b. Incorrect. A partnership return showing income, deductions, and other information is not required until the first tax year the partnership has income or deductions.

c. Correct. A return showing its income, deductions, and other information required must be filed every tax year of the partnership, regardless of whether the partnership has net income for the year.

d. Incorrect. A partnership return showing income, deductions, and other information required must be signed by only one partner. [Chp. 2]

38. What amount of penalties may the IRS assess a partnership that filed its partnership return two months after the due date of the return?

a. Incorrect. If a partnership fails to file a partnership return on time, it will be assessed a $50 penalty for each month the return is late, up to a maximum of 5 months, multiplied by the total number of partners in the partnership.

b. Correct. A partnership will be assessed $390 in penalties ($195 per month) for filing two months late. This amount is then multiplied by the total number of partners in the partnership during any part of the tax year for which the return is due.

c. Incorrect. A partnership will be assessed $150 in penalties if it is three months late in filing a return. This amount is multiplied by the total number of partners in the partnership during any part of the tax year for which the return is due.

d. Incorrect. A partnership will be assessed $200 in penalties if it is four months late in filing a return. This amount is multiplied by the total number of partners in the partnership during any part of the tax year for which the return is due. [Chp. 2]

39. If a partnership with ten or fewer partners can prove that there is reasonable cause for their inability to file a complete partnership return, the penalty will be waived. Which of the following would satisfy one element of the reasonable cause test?

a. Incorrect. One element of the reasonable cause test is that each partner is a natural person, other than a nonresident alien, or an estate.

b. Incorrect. In order to meet one element of the reasonable cause test, all of the partners must have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.

c. Incorrect. The status of the prior year partnership return is not an element of the reasonable cause test.

d. Correct. One element of the reasonable cause test is whether each partner's share of each partnership item is the same as that partner's share of every other item. [Chp. 2]

40. Which of the following is one requirement for determining substantial economic effect?

a. Incorrect. A basic requirement for substantial economic effect is that there must be a written, not oral, provision in the partnership agreement that reflects the terms of §704(b).

b. Correct. A basic requirement for substantial economic effect is that capital accounts are used to keep track of special allocations among partners.

c. Incorrect. A basic requirement for substantial economic effect is that liquidating distributions are made according to the ratio of the capital accounts.

d. Incorrect. A basic requirement for substantial economic effect is that negative capital accounts are restored before the partnership terminates. [Chp. 2]

41. Which of the following is the highest level consideration for the partnership using the tax year of a partner?

a. Incorrect. At least one partner using a fiscal tax year is not a stand alone consideration when determining the partnership's tax year.

b. Correct. If one or more partners own a majority interest in partnership profits and capital, the partnership must use the tax year of those partners.

c. Incorrect. The consideration of whether the principal partners have the same tax year is below the consideration of whether one partner owns a majority interest in the partnership profits and capital.

d. Incorrect. Whether the partnership has changed its tax year in the past is not a consideration in how a partnership conforms its tax year to its partners' tax year. [Chp. 2]

42. A partnership would use a tax year based on the analysis of deferred income to the partners when:

a. Correct. If neither the majority partners nor the principal partners establish a tax year, the partnership must generally use a tax year that results in the least aggregate deferral of income to the partners.

b. Incorrect. The partnership would use a tax year that results in the least aggregate deferral of income to the partners when no tax year is established by either the majority partners or principal partners.

c. Incorrect. The partnership would use a tax year that results in the least aggregate deferral of income to the partners when no tax year is established by either the majority partners or principal partners.

d. Incorrect. The partnership would use a tax year that results in the least aggregate deferral of income to the partners when no tax year is established by either the majority partners or principal partners. [Chp. 2]

43. How is the least aggregate deferral of income determined?

a. Incorrect. When determining the least aggregate deferral of income, the aggregate deferral is determined by adding the amounts calculated for each

partner that result from multiplying the deferral period by each partner's profit interest in the partnership for the year.

b. Correct. When determining the least aggregate deferral of income, deferrals that would result to all partners if one of the partners' tax year was the partnership's tax year are compared.

c. Incorrect. When determining the least aggregate deferral of income, first determine the number of months of deferral using one partner's tax year. A computation must be made for each partner, not just the majority partner, whose tax year is different from the other partners.

d. Incorrect. When determining the least aggregate deferral of income, the deferral period is multiplied by each partner's profit interest in the partnership for the year. [Chp. 2]

44. Under R.P 87-32, what percentage of gross receipts must occur in the last two months of the year under consideration to satisfy a requirement of the natural business year test?

a. Incorrect. More than 25% of the gross receipts for the year must occur during the last two months of the 12-month period being considered for the natural business year.

b. Incorrect. More than 25% of the gross receipts for the year must occur during the last two months of the 12-month period being considered for the natural business year.

c. Correct. More than 25% of the gross receipts for the year must occur during the last two months of the 12-month period being considered for the natural business year.

d. Incorrect. More than 25% of the gross receipts for the year must occur during the last two months of the 12-month period being considered for the natural business year. [Chp. 2]

45. What minimum period of gross receipts must a partnership have in order to qualify for the natural business year test under R.P.87-32?

a. Incorrect. A partnership must have at least 47 months, not 25 months, of gross receipts to be eligible for the natural business year test under R.P. 87-32.

b. Incorrect. A partnership must have at least 47 months, not 36 months, of gross receipts to be eligible for the natural business year test under R.P. 87-32.

c. Correct. A partnership must have at least 47 months of gross receipts to be eligible for the natural business year test under R.P. 87-32.

d. Incorrect. A partnership must have at least 47 months, not 60 months, of gross receipts to be eligible for the natural business year test under R.P. 87-32. [Chp. 2]

46. Which of the following would satisfy a requirement of a partnership making a §444 election?

a. Incorrect. A partnership meets one of the eligibility requirements to make a §444 election if it is not a member of a tiered structure unless all the members of the structure have the same tax year.

b. Incorrect. A partnership meets one of the eligibility requirements to make a §444 election if it does not choose a tax year where the deferral period is more than 3 months.

c. Correct. A partnership meets one of the eligibility requirements to make a §444 election if it has not made a §444 election before.

d. Incorrect. A partnership should not make a §444 election when it wants to establish a business purpose for having a different tax year. [Chp. 2]

47. Eligible partnerships must file a tax form to make a §444 election. Which form should these partnerships file?

a. Incorrect. Certain partnerships file Schedule M-3 to provide a detailed reconciliation between accounting net income and taxable income.

b. Incorrect. Form 1065-B is a U.S Partnership Return of Income for Electing Large Partnerships.

c. Correct. To make a §444 election, the partnership files Form 8716, Election to Have a Tax Year Other Than a Required Tax Year, with the Internal Revenue Service Center where it files its returns.

d. Incorrect. Form 8804-C is a certificate of partner-level items to reduce §1446 withholding. [Chp. 2]

48. What form should a partnership use to report a required tax payment for a year with an effective §444 election?

a. Correct. The amount of the required payment for any tax year in which a §444 election is in effect is reported on Form 720, Quarterly Federal Excise Tax Return.

b. Incorrect. A partnership would use the worksheet in the instructions for Form 1065 to figure the amount of the required payment. The required payment is then reported on Form 720, Quarterly Federal Excise Tax Return.

c. Incorrect. Form 8805 is a foreign partner's information statement of §1446 withholding tax.

d. Incorrect. Form 8813 is a partnership withholding tax payment voucher. [Chp. 2]

49. Under §708(b)(1)(A), a partnership terminates when:

a. Correct. Under §708(b)(1)(A), a partnership terminates when none of the partners carries on any part of the business or the financial operation of the partnership.

b. Incorrect. When one partner of a two-partner firm dies, the partnership remains in existence until all payments due to that estate have been made.

c. Incorrect. When a partnership willfully fails to file returns and make the payments due a §444 election will terminate. However, this willful failure does not terminate the partnership under 708(b)(1)(A

d. Incorrect. Even though a partnership may be considered dissolved for state law purposes, it remains in existence while it is in the process of winding up. [Chp. 2]

50. What is the effect of a death of a partner?

a. Incorrect. Upon the death of a partner, the deceased partner's distributive share of income for the year of death is not reported on that partner's final tax return.

b. Correct. Upon the death of a partner, the deceased partner's distributive share of income for the year of death is reported on the tax return of the partner's estate.

c. Incorrect. Upon the death of a partner, the year does not close for the partnership.

d. Incorrect. Upon the death of a partner, the year does not close for the partner. [Chp. 2]

51. Which of the following is an allowable method to allocate income and deduction items among partners when a new partner is admitted during the year?

a. Correct. One of the allocation methods is for the partnership to close the books prior to the change in interests. In doing so, the items occurring before the closure would be reflected according to the old allocation and the items occurring after the closure would be reflected according to the new allocation.

b. Incorrect. An allowable method involves allocating the items on a daily basis, rather than on a monthly basis.

c. Incorrect. Retroactive allocations of items of income and deduction when there is an admission of a new partner are not permitted.

d. Incorrect. An allowable method involves allocating the items on a daily basis, rather than on a quarterly basis. [Chp. 2]

52. Under §707(c), what is a characteristic of guaranteed payments?

a. Incorrect. Guaranteed payments are generally deductible as a business expense by the partnership.

b. Correct. Under §707(c), guaranteed payments to a partner are salary determined without reference to the partnership's income.

c. Incorrect. Guaranteed payments are not subject to tax withholding as payments to partnership employees are.

d. Incorrect. Receipt of guaranteed payments does not change the recipient partner's outside basis. [Chp. 2]

53. How are guaranteed payments issued to a partner for syndicating partnership interests treated?

a. Correct. Guaranteed payments to a partner for syndicating interests are capital expenditures.

b. Incorrect. Guaranteed payments to a partner for syndicating interests are not deductible by the partnership.

c. Incorrect. Guaranteed payments to a partner for syndicating interests must be included in the partner's tax return.

d. Incorrect. Guaranteed payments to a partner for syndicating interests cannot be amortized. [Chp. 2]

54. Generally, a partner is not treated as an employee. However, under §119, when can a partner be viewed as an employee?

a. Incorrect. Under §119, partners are not considered employees of a partnership for purposes of receiving healthcare benefits.

b. Correct. Even though the IRS contends that a partner should never be treated as an employee, under §119 a partner may be treated as an employee for the purposes of receiving tax-free meals and lodging for the employer's convenience.

c. Incorrect. Under §119, partners are not considered employees of the partnership for employment tax purposes.

d. Incorrect. Guaranteed payments are not treated as salary under other provisions of the Code. Thus, the partner is not considered an employee when he or she receives guaranteed payments. [Chp. 2]

55. When a partnership pays a partner's health insurance premiums for services performed, the amounts:

a. Incorrect. When a partnership pays for health insurance premiums on behalf of a partner for services rendered as a partner, the partner must include the amounts in his or her gross income.

b. Incorrect. When a partnership pays for health insurance premiums on behalf of a partner for services rendered as a partner, the amounts are deductible by the partnership as a business expense.

c. Incorrect. Payments for the premiums may not be amortized by the partnership.

d. Correct. When a partnership pays for health insurance premiums on behalf of a partner for services rendered as a partner, the amounts paid for medical insurance may be 100% deductible by the partner, if certain requirements are met. [Chp. 2]

56. Under §707(b) when is a loss on sale of property deductible?

a. Incorrect. A loss on a sale between a partner and a partnership is not deductible if the partner owns, directly or indirectly, more than fifty percent of the interest in capital or profits of the partnership (§707(b)(1)(A)).

b. Correct. A loss on a sale of property by a partner to a partnership is deductible when the partner owns, directly or indirectly, less than fifty percent of the interest in capital or profits of the partnership

c. Incorrect. No loss deduction is allowed when a loss results from a sale between two partnerships, where the same partners hold more than a 50% interest of the capital or profits in each partnership.

d. Incorrect. For disallowance of losses, various rules of constructive ownership are provided so that if close relatives of the seller or buyer are partners, the loss would be disallowed. [Chp. 2]

57. Under §721, how is a contribution of property for a partnership interest treated?

a. Incorrect. No gain or loss is recognized to the partnership upon a contribution of property to the partnership in exchange for a partnership interest.

b. Correct. Generally, under §721, upon a contribution of property to the partnership in exchange for a partnership interest, no gain or loss is recognized to the partnership or the partners. This provision is based on the idea that the creation of a partnership is not an appropriate time to tax the partner on gain or loss of the assets contributed to the partnership.

c. Incorrect. No gain or loss is recognized to the partner upon a contribution of property to the partnership in exchange for a partnership interest. If a partner sells an asset to the partnership, he or she would recognize gain or loss on the transfer.

d. Incorrect. Under §704(c) and Reg. §1.704-3, when a contribution to a partnership of property with a fair market value above or below basis is made, the precontribution gain or loss must be allocated to that partner at the time the partnership disposes of the property. [Chp. 3]

58. Under §704(c)(2) if, within the required time, a partner contributes property to a partnership that is distributed to another partner and then subsequently receives like-kind property:

a. Incorrect. The adjustment to the contributing partner's interest in the partnership and the distributed property adjusted basis is one of the results when within seven years, the partnership distributes to a partner property with a basis different from its fair market value that was contributed by another partner.

b. Correct. Under §704(c)(2), if, within the time limit, a partner contributes property to a partnership that is distributed to another partner and then receives like-kind property, the contributing partner does not recognize gain or loss to the extent of the like-kind property's value.

c. Incorrect. If, within seven years, the partnership distributes to a partner property with a basis different from its fair market value that was contributed by another partner, the contributing partner recognizes gain or loss equal to that which would have been allocated to him or her.

d. Incorrect. If, within seven years, the partnership distributes to a partner property with a basis different from its fair market value that was contributed by another partner, the distributed property is treated as sold by the partnership for its fair market value. [Chp. 3]

59. Which of the following is an approved basis for allocation of a precontribution gain under Reg. §1.704-3?

a. Incorrect. Distributive method is not an acceptable method of allocation for precontribution gain or loss under Reg. §1.704-3.

b. Correct. Traditional method is one of the three acceptable methods of allocation of precontribution gain or loss under Reg. §1. .704-3.

c. Incorrect. Guaranteed method is not an acceptable method of allocation for precontribution gain or loss under Reg. §1.704-3.

d. Incorrect. Restrictive method is not an acceptable method of allocation for precontribution gain or loss under Reg. §1.704-3. [Chp. 3]

60. Section 723 provides guidelines for the treatment of the basis of property that is contributed to a partnership. What is "inside basis"?

a. Incorrect. The basis for a partner's interest in the partnership is the outside basis.

b. Incorrect. The figure used to compute gain or loss on disposition of a partnership interest is the outside basis.

c. Correct. Inside basis is the partnership's basis for its assets.

d. Incorrect. Inside basis is the partnership's basis for its assets, which may include nonbusiness property. If the contributed property is nonbusiness property, the partnership's basis is the lesser of the partner's adjusted basis or the fair market value on the date contributed. [Chp. 3]

61. A partner should consider the effects of contributing business assets versus selling business assets to a partnership. When a partner sells business property to the partnership, what does the partnership's inside basis equal?

a. Correct. When a partner sells business property to the partnership, the partnership's inside basis would be equal to the property's purchase price.

b. Incorrect. The partnership's inside basis equals the property's purchase price, not the assessed value.

c. Incorrect. The fair market value of the property on the date contributed relates to a contribution of assets, not a sale.

d. Incorrect. If the contributed property is nonbusiness property, the partnership's basis is the lesser of the partner's adjusted basis *or* the fair market value on the date contributed. [Chp. 3]

62. When a partnership assumes a loan that has not been deducted by a cash basis partner and subsequently pays the loan, the deduction would be allocated:

a. Correct. Under §704(c), when the partnership pays assumed debt from a cash basis partner that has not deducted the debt, the entire deduction would be allocated to the contributing partner.

b. Incorrect. Under §704(c), when the partnership pays the assumed debt, the entire deduction is allocated to the contributing partner, not to the partners based on the partnership agreement.

c. Incorrect. Under §704(c), when the partnership pays the assumed debt, the entire deduction is allocated to the contributing partner, not equally among the partners.

d. Incorrect. Under §704(c), when the partnership pays the assumed debt, the entire deduction is allocated to the contributing partner, not to the general partners [Chp. 3]

63. A partner may receive a capital interest or a profits interest in a partnership. When a partner receives a profits interest in a partnership:

a. Incorrect. The fair market value of a capital interest transferred to a partner in payment for services rendered to the partnership constitutes a guaranteed payment.

b. Incorrect. A capital interest, not a profit interest, in a partnership entitles its owner to a pro-rata share of the partnership's assets if the partnership is dissolved.

c. Correct. A profits interest entitles one only to a share of the profits but not to any part of the assets that other partners have contributed or earned.

d. Incorrect. When a partner receives a capital interest, in exchange for services performed or to be performed the partner is immediately taxed on the value of that interest. When a partner receives an interest in future profits, the partner may not be taxed until profits are received.[Chp. 3]

64. Under R.P. 93-27, which of the following events where a partner receives a profit interest for services performed is nontaxable?

a. Incorrect. If the profits interest is a limited partnership interest in a publicly traded partnership, it is a taxable event.

b. Correct. If the interest is received by a person who is anticipating becoming a partner it is not a taxable event.

c. Incorrect. If the interest relates to a substantially certain and predictable stream of income from partnership assets, it is a taxable event.

d. Incorrect. If, within two years of its receipt, the partner disposes of the profits interest, it is a taxable event. [Chp. 3]

65. Four items will increase the original basis of a partner's interest. What is one of these items?

a. Incorrect. Nondeductible partnership expenses that are not capital expenditures will decrease the original basis of an interest.

b. Incorrect. The amount of any deduction for depletion with respect to oil and gas wells will decrease the original basis of an interest.

c. Incorrect. The amount of money and the adjusted basis of property distributed to the partner by the partnership will decrease the original basis of an interest.

d. Correct. The partner's share of an investment credit recapture adjustment to any partnership property basis that was reduced when the credit was taken will increase the original basis of an interest. [Chp. 3]

66. Under §731, the assumption of a partner's personal liability by a partnership is:

a. Incorrect. Accrued but unpaid liabilities of cash basis partnerships are not treated as liabilities for §752.

b. Incorrect. The fair market value of any part of an interest in partnership capital transferred to a partner in payment for services rendered to the partnership constitutes a guaranteed payment.

c. Incorrect. An assumption by a partnership of a partner's personal liability is treated as a distribution of money, not as a loan.

d. Correct. A decrease in a partner's share of liabilities, or an assumption by a partnership of a partner's personal liability, is treated as a distribution of money. [Chp. 3]

67. A partnership may acquire a real estate mortgage without an assumption of liability by the partnership or any of the partners. What is the result of this transaction?

a. Correct. When the partnership and the partners do not assume any liability related to the mortgage, all partners will be considered as sharing the mortgage liability in the same ratio as they share the profits.

b. Incorrect. When none of the partners has any personal liability, both general and limited partners increase, not decrease, their outside bases by the amount of the loan.

c. Incorrect. When none of the partners has any personal liability, both general and limited partners increase, not decrease, their outside bases by the amount of the loan.

d. Incorrect. Generally, a partner's share of partnership liabilities will be determined in accordance with the partner's ratio for sharing losses under the

partnership agreement. However, the loss-sharing ratio does not apply when a partnership acquires a real estate mortgage without an assumption of liability by the partnership or any of the partners [Chp. 3]

68. When calculating a partner's loss deduction:

a. Incorrect. When computing a partner's loss deduction, suspended losses are carried forward. Negative amounts at risk are included in the partner's gross income.

b. Correct. When computing a partner's loss deduction, the at-risk provisions are applied second, after the general loss limitation rule is invoked.

c. Incorrect. The first step of the calculation is that the deduction is limited to the partner's interest at the end of the partnership year before considering any losses.

d. Incorrect. When computing a partner's loss deduction, suspended losses are carried forward until a partner has a sufficient amount at risk in the activity to absorb them.[Chp. 3]

69. An exception to the at-risk rules for investments in real estate considers a taxpayer at risk on a nonrecourse loan provided by a:

a. Correct. A taxpayer is treated as being at risk on nonrecourse loans provided by government entities.

b. Incorrect. The at-risk exception for real estate loans applies to nonrecourse loans provided by a government entity, not a partnership.

c. Incorrect. The at-risk exception for real estate loans applies to nonrecourse loans provided by a government entity, not a manufacturing company.

d. Incorrect. The at-risk exception for real estate loans applies to nonrecourse loans provided by a government entity, not a charitable organization. [Chp. 3]

70. Which of the following meets the definition of a qualified person?

a. Incorrect. A dentist is generally not actively and regularly involved in lending money.

b. Incorrect. An accounting firm is generally not actively and regularly involved in lending money.

c. Incorrect. A law firm is generally not actively and regularly involved in lending money.

d. Correct. A bank meets the definition as a qualified person actively and regularly engaged in the business of lending money. [Chp. 3]

71. For which of the following would a partner be at risk?

a. Incorrect. A partner is generally not considered at risk for amounts borrowed if the lender has an interest in the activity.

b. Incorrect. A partner is generally not considered at risk for amounts borrowed if the lender is related to a person having an interest in the activity.

c. Correct. A partner is generally considered at risk for amounts borrowed that are secured by the partner's property other than property used in the activity.

d. Incorrect. A partner is generally not considered at risk for amounts borrowed when the partner has no personal liability. [Chp. 3]

72. For which item would a partner be considered not at risk?

a. Incorrect. A partner is generally considered at risk for amounts borrowed by the partnership for use in the activity if the partner is personally liable.

b. Correct. A partner is generally not considered at risk for amounts protected against loss through stop-loss agreements.

c. Incorrect. A partner is generally considered at risk for the amount of money and the adjusted basis of any property contributed to the activity.

d. Incorrect. A partner is generally considered at risk for the income retained by the partnership. [Chp. 3]

73. Income from wages or a salary is classified as:

a. Correct. Earned income such as wages or salary is classified as a material participation activity.

b. Incorrect. Income from interest, dividends, and annuities is classified as portfolio.

c. Incorrect. Passive items include income derived from activities considered passive under §469.

d. Incorrect. Service-generated is not one of the three classifications for activities.[Chp. 3]

74. Under §469, who would materially participate in a trade or business activity?

a. Incorrect. Limited partnership income is presumed to be passive income for a limited partner.

b. Incorrect. A taxpayer's activity resulting in gains and losses from disposal of related investment assets would be classified in the portfolio group.

c. Incorrect. Rental income from real or personal property generally is passive income, regardless of the taxpayer's level of participation.

d. Correct. A taxpayer materially participates if he or she is involved in the activity's operations on a regular, continuous, and substantial basis throughout the year. [Chp. 3]

75. Under §469, what is deemed to be portfolio income?

a. Incorrect. Portfolio income includes royalties not derived in the ordinary course of business.

b. Incorrect. Rental income from hotel operations is considered material participation because substantial services are provided as part of the activity.

c. Incorrect. Passive items include a limited partner's limited partnership income.

d. Correct. Guaranteed payments from a partnership for interest on capital are deemed to be portfolio income, whereas guaranteed payments from a partnership for services are deemed to be material participation income. [Chp. 3]

76. Under §469, passive losses can offset:

a. Incorrect. Usually, passive activity losses can be offset only against passive activity income.

b. Incorrect. Usually, passive activity losses can be offset only against passive activity income, not portfolio income.

c. Incorrect. Usually, passive activity losses can be offset only against passive activity income, not portfolio interest income.

d. Correct. Passive losses can generally offset only passive income. [Chp. 3]

77. Which of the following corresponds to the treatment of suspended losses?

a. Incorrect. Suspended losses are deductible first against income or gain from the passive activity and then against net income or gain from all passive activities.

b. Incorrect. When a passive activity is transferred in a nontaxable exchange, suspended losses are deductible only to the extent of recognized gains. Remaining losses may be deducted on disposal of the received property. A full deduction of suspended losses is generally taken in the year of disposal when a taxpayer makes a taxable disposition of an entire interest in a passive activity.

c. Correct. The amount of suspended losses carried forward from a particular activity is determined by the ratio of the net loss from that activity to the aggregate net loss from all passive activities for that year.

d. Incorrect. Suspended losses are realized at various times including when passive activity income occurs in future tax years or the taxpayer disposes of the entire interest in a passive activity in a taxable transaction. [Chp. 3]

78. Under §469, a taxpayer may be able to offset against nonpassive income up to $25,000 per year of passive rental real estate losses. To satisfy a requirement for this offset the:

a. Incorrect. The offset is available to those who actively participate in rental real estate activities. Limited partners cannot meet the active participation test.

b. Correct. One of the requirements is that the individual must own at least 10 percent of the fair market value of all interests in the rental property

c. Incorrect. The offset is available to those who actively, rather than materially participate in the activity. Active participation does not require regular, continuous, and substantial involvement with the activity.

d. Incorrect. The offset is eliminated when the taxpayer's adjusted gross income reaches $150,000. [Chp. 3]

79. Which of the following statements is correct regarding the active participation test for rental real estate losses?

a. Correct. Actively participating in arranging for others to make management decisions regarding the rental activity satisfies a requirement of the active participation test.

b. Incorrect. Active participation in rental real estate activities generally enables up to $25,000 of passive rental real estate losses to be offset against active and portfolio income.

c. Incorrect. The active participation test is easier to meet than the material participation test. It does not require regular, continuous, and substantial involvement with the activity, as does material participation.

d. Incorrect. The active participation test does not specify a required participation percentage or minimum hour level. [Chp. 3]

80. With the exception of unrealized receivables and appreciated inventory, how is a gain or loss on the sale or exchange of an interest in a partnership treated?

a. Incorrect. When a partnership interest is sold or exchanged, the transferor partner recognizes the gain or loss.

b. Incorrect. The Corn Products rule is inapplicable to the sale of a partnership interest

c. Correct. With the few exceptions provided in §751, the gain or loss from a sale or exchange of a partnership interest is a capital gain or loss.

d. Incorrect. With the few exceptions provided in §751, the gain or loss from a sale or exchange of a partnership interest is a capital gain or loss. [Chp. 4]

81. Which of the following is a provision of the IRS's regulations regarding the taxation of capital gains from sales or exchanges of partnership interests, S corporations, and trusts?

a. Incorrect. The proposed regulations provide that a selling partner of a publicly traded partnership may use the actual holding period of the interest sold in two instances: the interest is divided into identifiable units with ascertainable holding periods, and the selling partner can identify the portion transferred.

b. Incorrect. The proposed regulations provide that gain from the sale of a partnership interest that results in §1250 gain would not be treated as §1231 gain even if §1231 could apply to the disposition of the underlying property.

c. Correct. The proposed regulations provide that the holding period for a portion of a partnership interest would be determined based on a fraction equal to the fair market value of the portion to which the holding period relates over the fair market value of the entire interest.

d. Incorrect. The proposed regulations provide that when a collectibles gain or §1250 gain is involved in a sale or exchange of partnership interest, the amount of each type of gain would be determined as if the entity had sold all of its collectibles or §1250 property in a fully taxable transaction immediately before the transfer. [Chp. 4]

82. In certain circumstances, a disposition of a partnership interest qualifies for nonrecognition of gain or loss. Which of the following qualifies for such nonrecognition?

a. Incorrect. Gain is generally recognized when a cash basis partnership incorporates and normal operating debts exist that exceed the basis of transferred property.

b. Incorrect. An exchange of partnership interests does not qualify for nonrecognition under §1031 and, therefore, is equivalent to a sale.

c. Correct. Gain or loss is not recognized when one person transfers property to a corporation solely in exchange for its stock in the corporation, which gives the transferor control.

d. Incorrect. Gain is recognized to the extent that any debt assumed by the corporation or debt to which the partner's interest is subject exceeds the interest basis. [Chp. 4]

83. The author describes three alternate methods for incorporating a partnership. What is one of these alternative methods?

a. Incorrect. Distributing all assets and liabilities to partners in complete liquidation, with the partners then transferring undivided interests in the assets and liabilities to the corporation in exchange for stock under §351 is one of the alternate methods.

b. Incorrect. One of the incorporation methods provided is transferring all assets to the corporation in exchange for stock and the assumption of partnership liabilities and distributing stock to partners.

c. Correct. Transferring all interests to the corporation in exchange for stock under §351 is one of the alternative methods provided for incorporating a partnership.

d. Incorrect. Transferring all partnership assets and liabilities to the corporation in exchange for stock would not complete the incorporation. The stock would then have to be distributed to the partners in proportion to their partnership interests to complete the change in form. [Chp. 4]

84. Under §751, hot assets cause:

a. Correct. Hot assets cause ordinary income to be recognized.

b. Incorrect. Hot assets cause ordinary income to be recognized.

c. Incorrect. Hot assets cause the partnership to be treated like an aggregate rather than an entity.

d. Incorrect. Hot assets do not result in a pro-rata distribution of the assets, rather hot assets cause ordinary income to be recognized. [Chp. 4]

85. The author provides several examples of items that are considered unrealized receivables. Which of the following items fail to qualify as unrealized receivables?

a. Incorrect. Assets on which depreciation would be recaptured as ordinary income if the partnership had sold the asset result in an unrealized receivable, the recapturable depreciation.

b. Incorrect. The gain element in installment receivables from the sale of capital assets or §1231 assets is excluded, but that which relates to ordinary income is included in unrealized receivables.

c. Correct. Trade receivables from inventory sales and services rendered under the accrual method are not unrealized receivables.

d. Incorrect. Trade receivables from inventory sales and from services rendered under the cash method of accounting are included in unrealized receivables. [Chp. 4]

86. Under Reg. §1.751, which of the following items fails to qualify as inventory items?

a. Incorrect. Because accounts and notes receivable of an accrual basis partnership are neither capital assets nor §1231 assets, they are considered inventory items.

b. Correct. Neither capital assets nor property described in §1231 are considered inventory items.

c. Incorrect. Parcels of real property subdivided primarily for sale to customers in the ordinary course of business are inventory items.

d. Incorrect. Under Reg. §1.751-1(d)(2)(ii), all items considered to be unrealized receivables are considered inventory items. [Chp. 4]

87. Which of the following is correct regarding substantially appreciated inventory?

a. Incorrect. If there is substantial appreciation of all inventory items taken collectively, each item will be treated as substantially appreciated, even if a specific item has not appreciated at all.

b. Incorrect. Appreciation in assets is "substantial" when the items have a fair market value in excess of 120% of adjusted basis.

c. Incorrect. In applying the substantial appreciation test, inventory items are evaluated as a group rather than individually.

d. Correct. Because unrealized receivables usually are included at a zero basis in the tests to determine if the inventory is substantially appreciated, they greatly enhance the possibility of this event occurring. [Chp. 4]

88. Under §751, what is the relationship between the basis of substantially appreciated inventory and it's inside basis?

a. Incorrect. Because of the §751 basis calculations, the basis of substantially appreciated inventory is the same as it's inside basis. Inside basis is not exceeded by basis plus special adjustments.

b. Incorrect. Under the §751 basis calculations, the basis of substantially appreciated inventory is the same as it's inside basis. The basis is not less than inside basis.

c. Incorrect. Due to the §751 basis calculations, the basis of substantially appreciated inventory is the same as it's inside basis. Basis does not exceed inside basis.

d. Correct. As a result of the §751 basis calculations, the basis of substantially appreciated inventory is the same as it's inside basis.

89. Section 743(a) describes the general rule for the treatment of inside basis of partnership property resulting from a sale or distribution of a partnership interest. Generally, the inside basis of a partnership asset is:

a. Incorrect. Under §743(a), the general rule is that the inside basis of a partnership asset does not change because of current or liquidating distributions.

b. Correct. The §743(a) general rule is that the inside basis of a partnership asset does not change when a partnership interest is sold or when there is a current or liquidating distribution.

c. Incorrect. The inside basis of a partnership asset does not change under §743(a) when a partnership interest is sold.

d. Incorrect. For §743(a), the general rule is that the inside basis of a partnership asset does not change when there is a liquidating distribution of a partnership interest.

If an election under §754 is in effect and if a partner's interest is sold or exchanged, the partner dies, or a §761(e) distribution of a partnership interest is made, §743(b) provides that the transferee partner's special basis for those partnership assets whose bases are adjusted is the partner's share of the common partnership basis plus or minus any special basis adjustments. [Chp. 4]

90. Which Tax Code provision allows a basis adjustment on a transfer of a partnership interest?

a. Incorrect. Section 691 does not permit a basis adjustment on a transfer of a partnership interest. Instead, no step-up in basis is permitted for unrealized

receivables, since an increase in basis of such assets would contradict §691's policy, relating to income in respect of a decedent.

b. Incorrect. Section 743(b) permits an acquiring partner a basis adjustment to his or her undivided interest in the partnership assets.

c. Correct. Section 754 permits a basis adjustment upon the transfer of a partnership interest or the distribution of partnership assets to a partner.

d. Incorrect. Section 755 provides rules for allocating the basis adjustment among partnership assets. [Chp. 4]

91. What is the effect on inside basis of a partnership's §754 election?

a. Incorrect. If the partnership makes an election under §754, inside basis will be adjusted as to the partner who acquired the interest.

b. Incorrect. Section 743(b) provides that the partnership shall increase or decrease the adjusted basis of partnership property by the transferee's interest basis in partnership and the transferee's share of adjusted basis of all partnership property.

c. Incorrect. Section 743(b) provides that the partnership shall increase or decrease the adjusted basis of partnership property by the transferee's interest basis in partnership and the transferee's share of adjusted basis of all partnership property.

d. Correct. If the partnership makes an election under §754, inside basis will be the same as what the partner paid for the interest. [Chp. 4]

92. Under R.R. 60-352, how is a gift of a partnership interest treated if the partnership has installment notes receivable?

a. Correct. Under R.R. 60-352, if the partnership has installment notes receivable the gift of an interest may be considered a disposition thereof.

b. Incorrect. An exception under R.R. 60-352 exists to the general rule of treating gifts as nontaxable transfers.

c. Incorrect. A gift may be considered an anticipatory assignment of income by the donor if the partnership uses the cash method of accounting and has accounts receivable at the time of transfer.

d. Incorrect. Under R.R. 75-194, a gift will be treated as part gift and part sale if the donor's share of partnership liabilities exceeds the donor's basis in the partnership. [Chp. 4]

93. Under §731 which of the following statements is correct?

a. Incorrect. Under §731, the general nonrecognition rule provides that a partner receiving such distributions generally recognizes no gain or loss.

b. Correct. If the distribution is in liquidation of the partner's interest in the partnership and no other property is distributed, loss is recognized to the extent the adjusted basis of the partner's interest exceeds the sum of any money, and the basis to the distributee of any unrealized receivables and invento-

ries received. This is treated as a loss from the sale or exchange of the partner's interest (§731(a)).

c. Incorrect. Under §731, the general nonrecognition rule provides that, ordinarily, the distribution of cash or property by the partnership to the partners is not a taxable event.

d. Incorrect. Gain is recognized by a partner to the extent any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution (his or her "outside basis"). (§731(a)(1)). [Chp. 5]

94. When a partner receives a fixed sum for total retirement payments associated with the partner's property interest, the partner may elect to report a proportionate part of the gain or loss each year. What is required to make this election?

a. Incorrect. This election must be made in the first tax year for which a payment is received.

b. Incorrect. Notifying the IRS of the first receipt of the retirement payments is not a requirement for making this election.

c. Correct. This election must be made in the first tax year for which a payment is received.

d. Incorrect. A statement must be attached to the partner's tax return indicating the election and showing the computation of the gain included in gross income.[Chp. 5]

95. When a partner receives property in a complete liquidation of the interest in a partnership, what is the basis of property before the reduction for cash received?

a. Incorrect. The basis of property (other than money) distributed to a partner in a nonliquidating distribution is the asset's adjusted basis to the partnership immediately before the distribution.

b. Incorrect. In a nonliquidating distribution, the basis of distributed property is the carryover basis.

c. Correct. In a complete liquidation of a partner's interest, the basis of the distributed property is the partner's adjusted basis in their partnership interest, reduced by any money distributed to the partner in the same transaction.

d. Incorrect. When a partnership distributes property other than money in a nonliquidating distribution, the partner has the same basis in such property as the partnership had. [Chp. 5]

96. When a partner receives a distribution of property other than cash, a special basis adjustment may be selected by the partner if two conditions are met. What is one of these conditions?

a. Incorrect. The special adjustment to basis must be made if three conditions exist at the time the partner receives an interest, including a division of basis among properties, upon liquidation of the partner's interest immediately after the transfer, will shift basis from property that does not qualify for depreciation, depletion, or amortization to property that does qualify.

b. Incorrect. One of the conditions for a partner to choose a special basis adjustment is if the distribution is made within two years of acquiring any part of his or her partnership interest by a sale or exchange or on the death of a partner.

c. Incorrect. The special adjustment to basis must be made if three conditions exist at the time the partner receives an interest, including the fair market value of all partnership property being more than 110% of its adjusted basis to the partnership.

d. Correct. If a partner receives a distribution of property other than cash, the partner may choose a special basis adjustment if the partnership has not chosen the optional adjustment to basis. [Chp. 5]

97. Under §751(b), which of the following events is treated as a sale or exchange?

a. Incorrect. In kind receipt of a proportionate share of the partnership's unrealized receivables is not treated as a sale or exchange. Therefore §751 does not apply and the general nonrecognition rule controls the tax consequences of the distribution.

b. Incorrect. In kind receipt of a proportionate share of the partnership's substantially appreciated inventory items is not treated as a sale or exchange. Therefore §751 does not apply and the general nonrecognition rule controls the tax consequences of the distribution.

c. Correct. Receipt of a disproportionate share of partnership assets is treated as a sale or exchange. Such a distribution normally results in recognition of gain or loss to the partner and the partnership.

d. Incorrect. Receipt of a proportionate share of partnership assets in kind is not treated as a sale or exchange. [Chp. 5]

98. When determined by reference to the partnership income, how are cash payments issued to a deceased or retiring partner treated?

a. Correct. If cash payments made to a retiring or deceased partner are determined by reference to the partnership income, they are considered a distributive share, or income distribution.

b. Incorrect. If cash payments made to a retiring or deceased partner are not determined by reference to the partnership income, they are considered guaranteed payments.

c. Incorrect. If cash payments made to a retiring or deceased partner are determined by reference to the partnership income, the payments reduce, not increase, the amount of partnership income available to continuing partners.

d. Incorrect. Payments made to a retiring or deceased partner are not considered capital income whether or not the payments are determined by reference to the partnership income. [Chp. 6]

99. Cash payments that are determined without reference to the partnership income may be made to a retiring or deceased partner. What is the effect of these payments?

a. Incorrect. If it is a distributive share (cash payments are determined by reference to the partnership income), it increases the recipient's outside basis by the amount of the distributive share. Payments that are not determined by reference to the partnership income, guaranteed payments, do not affect outside basis at all.

b. Incorrect. When a payment is a distributive share, the recipient's outside basis is increased by the amount of the distributive share, then outside basis is reduced by the amount of cash actually distributed. Guaranteed payments do not affect outside basis at all.

c. Correct. If cash payments made to a retiring or deceased partner are not determined by reference to the partnership income, they produce a deduction from gross income to arrive at the partnership's taxable income.

d. Incorrect. When payments are determined by reference to the partnership income, the amount of partnership income available to continuing partners is reduced. [Chp. 6]

100. How is cash paid to a retiring partner in exchange for the partner's interest in partnership property treated?

a. Correct. Under §736(b), the cash payment is treated as a distribution by the partnership.

b. Incorrect. Under §736(a) payments are treated as distributive shares if computed with regard to partnership income.

c. Incorrect. Under §736(a) payments are treated as guaranteed payments if computed without regard to partnership income.

d. Incorrect. Under §736(b), the recipient does not generally realize ordinary income on the distribution. [Chp. 6]

101. The effect of §736(b) payments varies depending on the character of the distribution. Which of the following payments are considered a return of capital?

a. Incorrect. Under §751(b), liquidating cash payments in exchange for the partner's interest in substantially appreciated inventory would produce ordinary income.

b. Incorrect. Section 736(b) payments do not include payments for goodwill in excess of the partner's share of the goodwill's basis to the partnership that have not been specifically provided for in the partnership agreement. Thus, amounts received in exchange for the partner's interest in the goodwill of the partnership are taxed under §736(a) as ordinary income.

c. Correct. When the cash payment is made in exchange for the interest of the retiring or deceased partner in partnership property, it is treated as a current distribution by the partnership. Liquidating cash payments under §736(b) are considered a return of capital to the extent of the partner's basis in the partnership, and capital gain is recognized to the extent of any excess.

d. Incorrect. Section 736(b) payments do not include payments for unrealized receivables. Payments in exchange for the partner's interest in unrealized receivables are subject to §736(a) rather than §736(b). [Chp. 6]

102. A partnership may find it more feasible to distribute property in addition to cash in a liquidation of a retiring partner's interest. What effect does this have?

a. Incorrect. Some or all of the withdrawing partner's interest may be liquidated through property distributions.

b. Incorrect. When a partnership distributes property in liquidation, the property received takes a basis equal to the partner's outside basis less any money also distributed.

c. Correct. If the partnership does not have §751 property or if the distributions do not change the proportionate ownership of such property, the tax treatment of liquidating property distributions is essentially the same as nonliquidating distributions.

d. Incorrect. When a partnership distributes property in liquidation, there is usually no gain or loss recognized by the partner. [Chp. 6]

103. When determining a withdrawing partner's basis of distributed property from a liquidation:

a. Incorrect. As a last step, if there is any basis remaining in the partnership, that basis is allocated to any other assets received, in the ratio of their adjusted basis to the partnership.

b. Correct. Cash distributions reduce the withdrawing partner's basis dollar for dollar and are counted before subsequent or contemporaneous distributions of other property.

c. Incorrect. Cash distributions are counted before subsequent and contemporaneous distributions of other property. Then any remaining basis is allocated to distributed unrealized receivables in an amount equal to the partnership's adjusted basis in such property.

d. Incorrect. Cash distributions are counted before subsequent and contemporaneous distributions of other property. Then any remaining basis is allo-

cated to distributed unrealized receivables and inventory, regardless of whether it is substantially appreciated, in an amount equal to the partnership's adjusted basis in such property. [Chp. 6]

104. Gain may be recognized in a distribution of property in liquidation. Under which circumstance would gain be recognized?

a. Incorrect. Gain realized by the withdrawing partner on the subsequent disposition of inventory is ordinary income unless the disposition occurs more than five years after the distribution.

b. Incorrect. Loss is recognized only if the sum of the cash received plus the basis of distributed unrealized receivables and inventory is less than the adjusted basis of the partner's interest before the liquidating distribution and no other property is distributed.

c. Correct. Gain is recognized only when the cash received exceeds the tax basis of the partner's interest.

d. Incorrect. Presumably, anyone who receives the inventory from the withdrawing partner as a gift or inheritance is not bound by the five-year holding period requirement. Thus, the gain realized by the withdrawing partner on subsequent disposition of this inventory is ordinary income. [Chp. 6]

105. In a nonliquidating distribution, what results when the inside basis exceeds a partner's outside basis?

a. Incorrect. A §754 election can be made to increase the inside basis if the inside basis exceeds a partner's outside basis in a nonliquidating distribution.

b. Incorrect. A disproportionate distribution occurs when either less than or more than the partner's proportionate share of the partnership's unrealized receivables and substantially appreciated inventory is received.

c. Incorrect. When a partnership distributes property in liquidation, there is usually no gain or loss recognized by the partner. The property received takes a basis equal to the partner's outside basis less any money also distributed.

d. Correct. Basis could be lost if the inside basis exceeds a partner's outside basis. [Chp. 6]

106. A partnership must request permission to revoke a §754 election. When will the IRS deny the request?

a. Incorrect. Permission to revoke generally is granted for business reasons, in general.

b. Incorrect. Permission to revoke generally is granted if the primary purpose is for an increase in the frequency of interest transfers.

c. Correct. If it appears as though the primary purpose is to avoid downward adjustments to basis otherwise required under the election, permission to revoke a §754 election is not granted.

d. Incorrect. Permission to revoke generally is granted if the primary purpose is a change in the nature of the business. [Chp. 6]

107. Prior to the IRS issuance of the entity classification regulations (Notice 97-1; TD 8697), limited liability companies were classified for federal tax purposes based on the:

a. Incorrect. The number of members was evidentiary but not determinative in the classification of limited liability companies.

b. Correct. The entity classification regulations replaced the prior fact-intensive classification regulations that were based on the historical differences between partnerships and corporations under local law (i.e., the "Kintner regs." under §301.7701).

c. Incorrect. Limited liability companies were not classified based on the membership agreement.

d. Incorrect. The written determination of the members of the limited liability company did not determine its classification. [Chp. 7]

108. What does the author view as the largest benefit of an LLC over a C corporation?

a. Correct. The biggest benefit of an LLC over a C corporation is that the LLC is subject to one level of tax which is paid by the members of an LLC. C corporations pay an entity level federal and state income tax. The distributed income of a C corporation may be taxed twice as the shareholder is also taxed on dividends received from the C corporation.

b. Incorrect. Some states' LLC statutes, including. California), severely restrict the types of businesses that may elect to form as LLCs

c. Incorrect. LLCs must generally have the same tax year as the members of the LLC and, as a result, most LLCs will be restricted to a calendar year.

d. Incorrect. Actually, a C corporation is easier to convert to an S corporation. LLCs are first required to elect to be taxed as a corporation before they can file Form 2553 and elect S corporation status. [Chp. 7]

109. What is another tax advantage that an LLC, classified as a partnership, has over a regular or C corporation?

a. Incorrect. Both corporations and LLCs have a variety of filing requirements imposed on them by state law.

b. Incorrect. Neither corporations nor LLCs are inherently tax-exempt organizations.

c. Incorrect. LLCs and corporations both provide some form of limited liability

d. Correct. A C corporation may not specially allocate income or loss to its shareholders. An LLC, because it is treated as a partnership for income tax

purposes, may specially allocate income or loss within the provisions of §704(b). [Chp. 7]

110. What is a possible advantage that S corporations have over LLCs?

a. Incorrect. S corporations cannot have a shareholder which is a corporation, partnership, LLC, or unincorporated entity other than a qualified estate or trust. LLCs can have any form of entity as a member.

b. Incorrect. S corporation shareholders cannot include indebtedness of the S corporation in basis. The tax basis of an LLC membership interest includes the member's share of the entity's indebtedness that may shelter from current gain recognition any operating distributions of cash.

c. Incorrect. S corporations are limited to a single class of stock. LLCs can have multiple classes of stock outstanding and an infinite variety of interests.

d. Correct. S corporations have been a creature of tax law since the 1950s and, as a result, there is far more case law and tax resource data available. Many believe important federal tax issues related to LLCs remain unsettled. [Chp. 7]

111. Limited liability companies can have advantages over limited partnerships. For example, limited partners involved in running the limited partnership can be classified as:

a. Incorrect. Participation in management could result in a general partner classification and the loss of limited liability, not the ability to pass through losses.

b. Incorrect. A member is an LLC designation. Limited partners who participate in the management of the limited partnership can be classified as general partners and lose the benefit of limited liability.

c. Correct. Limited partners who participate in the management of the limited partnership can be classified as general partners and lose the benefit of limited liability. All members of an LLC can fully participate in management without jeopardizing their protection from such liability.

d. Incorrect. The term "silent partner" is not a tax concept but one used by the general population to describe an undisclosed business partner. [Chp. 7]

112. In a limited liability company treated as a partnership, all entity debt is essentially:

a. Incorrect. A recourse liability is where the partner bears the economic risk of loss. Since no member of an LLC is personally liable for the LLC's liabilities, they do not have recourse liability.

b. Correct. In a limited liability company, no member is personally liable for the LLC's liabilities, except to the extent of their investment in the LLC (R.R. 88-76). Thus, no member of an LLC bears the risk of loss for the LLC's

liabilities whether recourse or nonrecourse. Thus, even recourse debt can be treated as nonrecourse.

c. Incorrect. An assumable loan refers to the ability of another to take over the debt. There is nothing inherent in the limited liability company form that makes all entity debts assumable.

d. Incorrect. A subordinated loan refers to the junior position of a loan with another loan taking priority over it. There is nothing inherent in the limited liability company form that makes all entity debts subordinated. [Chp. 7]

113. What is one advantage that LLCs have over general partnerships?

a. Incorrect. LLCs are subject to disclosure, recordkeeping, and reporting requirements.

b. Correct. LLCs can restrict management powers to a subset of the members or to non-member managers. Management of a general partnership is vested in the general partners who act in a fiduciary capacity.

c. Incorrect. A disadvantage of LLCs is that managers who are actively involved in the management of the LLC will be subject to self-employment tax.

d. Incorrect. The nontaxable fringe benefits available to LLC members are the same as those available to partners in a partnership. [Chp. 7]

114. Which of the following is a disadvantage of LLCs?

a. Incorrect. Where salaries of C corporation shareholders are often characterized as "unreasonable compensation," the LLC doesn't run as much of a risk. Generally, the Service doesn't mind if the member takes the payment as salary or as a distributive share of the LLC income.

b. Correct. The risk of inadvertent termination is higher in the LLC as certain procedural requirements must be met in order to continue the LLC in the event of bankruptcy, death, resignation, or withdrawal of a member.

c. Incorrect. Where S corporations cannot have nonresident alien shareholders, LLCs can have nonresident alien members.

d. Incorrect. Where S corporation shareholders cannot include indebtedness of the S corporation in basis, the tax basis of an LLC membership interest includes the member's share of the entity's indebtedness that may shelter from current gain recognition any operating distributions of cash. [Chp. 7]

115. Although there are benefits of professional firms operating as an LLC, a professional receives no protection from liability for:

a. Incorrect. An LLC can protect its members from personal liability on working capital loans since entity loans of an LLC are nonrecourse.

b. Incorrect. An LLC can shield the members from liabilities of the business.

c. Correct. LLCs do not protect a professional from liability for their own acts.

d. Incorrect. It is possible for an LLC to protect its members from personal liability on the LLC's lease obligations. [Chp. 7]

116. How does an LLC provide an attractive alternative to a limited partnership for charities engaged in fund-raising ventures?

a. Incorrect. Charitable fund-raising ventures are typically of short duration and should not involve long-term lease obligations. Such obligations could jeopardize charitable status and constitute unrelated business taxable income.

b. Incorrect. There is a greater risk of creating fiduciary obligations by using a limited partnership where general partners can have such an obligation to the limited partners.

c. Correct. The LLC form provides an attractive alternative to a limited partnership since the liability is limited and the charity would not be required to undertake personal liability as a general partner. The LLC allows the charity to maintain control over LLC activities to ensure that these functions are consistent with the charity's tax-exempt purpose.

d. Incorrect. Charitable fundraising activity should not involve loans for working capital. Charities as exempt organizations are prohibited from engaging in business activities and can be subject to unrelated business taxable income taxation if they do. [Chp. 7]

117. What is one of the required conditions under proposed regulations to exclude a member's share of the LLC's income and loss from net earnings from self-employment?

a. Incorrect. If the LLC's controlling documents fail to designate a manager, the member will be considered a manager for self-employment tax purposes.

b. Incorrect. If the LLC statute does not elect managers, the member will be considered a manager for self-employment tax purposes.

c. Correct. When the LLC member is not a manager, one of the requirements is met in order for the member's share of income or loss from the LLC to not be included in net earnings from self-employment.

d. Incorrect. The regulations are unclear as to whether an LLC member who serves as an investor would be required to include his or her share of income or loss in the net earnings from self-employment. It is possible that the investor could be subject to the tax. This is a major criticism of the proposed regulations. [Chp. 7]

118. For tax reporting purposes, four types of taxpayers are required to use the accrual method of accounting. While LLCs are excluded from the list by name, their substance may require them to use the accrual method of accounting. When may an LLC use the cash method of accounting?

a. Incorrect. Tax shelters are one of the four types of taxpayers that must use the accrual method of accounting. In the LLC, if members are considered li-

mited partners and they are allocated all of the entity's losses, the LLC would qualify as a tax shelter. As a result, the LLC would be required to use the accrual method of accounting.

b. Incorrect. This classification alone is not enough to make a determination regarding the method of accounting. A limited entrepreneur may or may not be required to use the accrual method of accounting.

c. Incorrect. If nonparticipating members of the LLC are allocated more than 35% of the entity's losses, the LLC would be required to use the accrual basis method of accounting. If the members were actively participating in management and were allocated at least 65% of the losses, the LLC could use the cash method of accounting since it would not be considered a syndicate.

d. Correct. An LLC may use the cash method of accounting when the entity has no losses because the entity would not be characterized as a syndicate. [Chp. 7]

119. Existing entities can convert to limited liability companies. However, which entity will generally find the expense of conversion greater than the benefits of the LLC?

a. Correct. A C corporation will be subject to double taxation when converting to an LLC. Since the conversion methods result in corporate liquidation, there is both a double tax and a loss of tax attributes. This will oftentimes make it too expensive for a corporate entity to take advantage of the LLC form.

b. Incorrect. In some cases, a conversion of an S corporation to an LLC may be beneficial since relief from the double tax burden is afforded the S corporation shareholder to the extent that the gain recognized does increase the basis of the shareholder so that the gain recognized on the distribution to the shareholder is reduced accordingly. However, an existing S corporation having substantially appreciated assets that are subject to the built-in gains tax might not find the conversion to be sensible.

c. Incorrect. If the conversion were structured properly, a partnership could convert to an LLC without incurring income tax.

d. Incorrect. If the conversion were structured properly, a limited partnership could convert to an LLC without incurring income tax. [Chp. 7]

120. Converting an existing entity to an LLC may trigger local taxes. For example, in California, which of the following circumstances would result in taxation?

a. Incorrect. When a C corporation converts to an LLC and a stock interest is surrendered in exchange for liquidation distributions of tangible personal property, because the transaction is not considered a sale, it is not taxable.

b. Correct. When a C corporation converts to an LLC and liquidation distributions are made to a creditor-shareholder in fulfillment of corporate debt,

the "sale of assets" is taxable, since the discharge of debt is deemed consideration.

c. Incorrect. Upon conversion of a partnership to an LLC, a partnership that does not terminate is not subject to any county or city transfer taxes on California real property as a result of the conversion.

d. Incorrect. Upon conversion of a partnership to an LLC where the LLC is comprised of at least 80% of the partnership's owners and it acquires at least 80% of the assets, no sales tax is triggered. [Chp. 7]

Glossary

Accounts receivable: Funds owed typically to a business creditor for services rendered or merchandise sold.

Adjusted basis: The original basis of property increased by improvements and reduced by depreciation.

Alternative minimum tax: A tax triggered when certain tax benefits reduce regular income tax below a certain threshold.

Bad debts: Legally binding debts owed a taxpayer that are partially or totally worthless and uncollectible.

Business purpose: A requirement that an expense claimed as a deduction from taxable business income must serve a genuine business purpose.

Capital account: A bookkeeping account for long-term assets.

Capital gains: Gain from the disposition or exchange of a capital asset.

Capital interest: An ownership share in the equity of a business.

Capital loss: Loss from the disposition or exchange of a capital asset.

Check-the-box regulations: A series of regulations classifying certain business entities and providing a taxpayer with elections under Form 8832.

Family limited partnership: A family member limited partnership under §704(e).

Guaranteed payment: A payment that is made to partners without regard to the partnership's income or loss.

Inside basis: A popular term for the basis of property in the hands of a partnership.

Liquidating distribution: A distribution from an entity during the process of its liquidation.

Outside basis: A popular phrase for a partner's basis in their partnership interest as distinct from their share of the partnership's basis in its property.

Recapture: Inclusion of depreciation deducted in previous years in this year's taxable income.

Self-employment tax: Similar to Social Security and Medicare taxes but for self-employed individuals.

Tax preference: An item of income, gain, or loss that a taxpayer must include when calculating the Alternative Minimum Tax (AMT).

Tax year: An annual accounting period for reporting income and keeping records.

Unrealized receivables: Receivables that have not yet been collected.

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