7 LLCs and Partnerships

Introduction

Traditionally, there have been two forms of partnerships in the United States, the general partnership and the limited partnership. **In a general partnership,** each partner has rights to manage the enterprise and to deal with outsiders on behalf of the partnership. All partners have joint and several liability for partnership obligations.

In a limited partnership, there are generally two classes of partners. General partners usually have unlimited responsibility with respect to partnership debts, but also have considerable powers to bind the partnership on business matters. In contrast, **limited partners** usually have protection from claims of partnership creditors, and only risk the property they have invested in the partnership, or are contractually obligated to contribute to the partnership. As a corollary, limited partners usually have severe restrictions on their rights to participate in management.

In the 1990s, most states have permitted two new types of business entities, the limited liability company (LLC) and the limited liability partnership (LLP). **Although the two names are similar, the entities are quite different in substance.**

The limited liability partnership is a variation on the traditional general partnership. All partners have management rights and unlimited personal liability for certain partnership obligations. The partners, however, have only limited liability with respect to claims arising from the malpractice of other partners. In the 1990s, major international accounting partnerships converted from general partnerships to limited liability partnerships.

As of 1/2/97, the District of Columbia and 47 states had LLP statutes; the others were expected to enact them this year. The states that did not have LLPs are Arkansas, Vermont, and Wyoming. (*Source: Tax Notes*, March 10, 1997.)

The limited liability company, by contrast, is a hybrid between the traditional general partnership and a corporation. These entities were first permitted by the state of Wyoming in the late 1970s in an effort to stimulate investments in Wyoming properties. As of 1/2/97, all 50 states and the District of Columbia had LLC acts. (*Source: Tax Notes,* March 10, 1997.)

Caution. Many states base limited liability company statutes on partnership statutes. Accordingly, they require a limited liability company to have two or more members. Some states, however, base their limited liability company laws on corporate statutes and allow a limited liability company to have a single member. These laws are changing rapidly at the state level. Be certain to check the statute for a particular state if there is a provision allowing a single-member limited liability company.

Although the non-tax aspects of partnerships are important, it is necessary to understand the federal income tax treatment of partnerships to properly evaluate the use of this business form.

In general, the **federal tax laws** recognize only two primary business forms: the **corporation and the partnership.** There are variations of each type. For example there are real estate trusts, small business investment companies, and S corporations. **The S corporation is so widely used that it is often considered a third type of tax entity.** Most closely held businesses can choose to operate as a partnership, a C corporation, or an S corporation. **Each has its unique tax rules.** Each of these entities can be the best option under certain circumstances. Thus the tax practitioner must be ready to recognize client situations where one form is preferred over the other two.

The central focus of the tax law is to treat a partnership as a conduit entity and a mere aggregation of its partners' resources committed to the business. Thus the partnership itself is not subject to any federal income tax. The partners must report their shares of the partnership's income and deductions on their own tax returns. Transfers of property to and from the partnership to its partners, and vice versa, are generally tax-free (although there are complicated exceptions).

A corporation, by contrast, is generally taxable on its own income. Its losses are generally kept at the corporate level and may only offset the corporation's income in other years. Distributions from a corporation to its shareholders are subject to a second round of taxation. **A major exception to these rules lies with the election under Subchapter S to pass income and losses from a corporation to its shareholders.**

Approximately 50% of all corporations filing U.S. tax returns are now S corporations.

Tax Classifications of Limited Liability Companies

A limited liability company has features resembling those of a partnership and features (especially limited liability) resembling those of a corporation. Since the limited liability company has never been recognized as a distinct entity for federal tax purposes, the IRS has devoted considerable effort to the problem of classification. Some of the history of this problem has been covered in the 1994 and 1996 editions of the *Farm Income Tax Book.*

Limited Liability Companies Before 1997

Before 1997, the IRS could classify a limited liability company either as a corporation or as a partnership. It did so based on the predominance of certain corporate characteristics:

1. Continuity of life,
2. Transferability of interests,
3. Centralized management, and
4. Limited liability of owners.

An organization that had at least three of the above characteristics was treated as a corporation, regardless of the organization's designation (**Treas. Reg.** §301.7701-3, before replacement in late 1996).

The uncertainty of tax classification was a serious obstacle to the limited liability company. Companies would find it necessary to request rulings on their tax status, and the result was not always satisfactory. Furthermore, the IRS would not even attempt to address the tax classification of single-owner limited liability companies.

Limited Liability Companies After 1996

Fortunately, the tax classification problem disappeared on January 1, 1997. In late 1996, the IRS issued a regulation that provides simple election and default rules for unincorporated businesses (known as the "check the box" regulation). **In general, an unincorporated domestic organization with two or more owners receives a default classification as a partnership.**

A **domestic organization** with only one member is disregarded as a separate organization for tax purposes. It is treated as a proprietorship if it is owned by an individual. If owned by a corporation or other business entity, it is treated as a branch or division [**Treas. Reg.** §301.7701-3(b)]. A foreign organization is classified as a partnership if any member has unlimited liability for business debts, and as an association (corporation) if no member has such liability.

Any unincorporated organization may elect out of its default status. Thus, a domestic organization may elect to be classified as a corporation for tax purposes, and a foreign organization could go either way. **The election must be filed on Form 8832** within 75 days **following the date on which the status is to be effective** [**Reg.** §301.7701-3(c)(1)(i)]. An entity may not file an election to change its status until **60 months** have expired from the last election [**Treas. Reg.** §301.7701-3(c)(1)(ii)].

Form **8832**
(December 1996)
Department of the Treasury
Internal Revenue Service

Entity Classification Election

OMB No. 1545-1516

Please Type or Print	Name of entity	**Employer identification number (EIN)**
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country.	

1 Type of election (see instructions):

a ☐ Initial classification by a newly-formed entity (or change in current classification of an existing entity to take effect on January 1, 1997)

b ☐ Change in current classification (to take effect later than January 1, 1997)

2 Form of entity (see instructions):

a ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.

b ☐ A domestic eligible entity electing to be classified as a partnership.

c ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.

d ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.

e ☐ A foreign eligible entity electing to be classified as a partnership.

f ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

3 Election is to be effective beginning (month, day, year) (see instructions) . . . . ▶ ___/___/___

4 Name and title of person whom the IRS may call for more information

5 That person's telephone number

Consent Statement and Signature(s) (see instructions)

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

Signature(s)	**Date**	**Title**

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Paperwork Reduction Act Notice

We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . 1 hr., 20 min.
Learning about the law or the form . . . 1 hr., 41 min.
Preparing and sending the form to the IRS . . . . 17 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **DO NOT** send the form to this address. Instead, see **Where To File** on page 3.

Purpose of Form

For Federal tax purposes, certain business entities automatically are classified as corporations. See items **1** and **3** through **8** under the definition of corporation on this page. Other business entities may choose how they are classified for Federal tax purposes. Except for a business entity automatically classified as a corporation, a business entity with at least two members can choose to be classified as either an association taxable as a corporation or a partnership, and a business entity with a single member can choose to be classified as either an association taxable as a corporation or disregarded as an entity separate from its owner.

Generally, an eligible entity that does not file this form will be classified under the default rules described below. An eligible entity that chooses not to be classified under the default rules or that wishes to change its current classification must file Form 8832 to elect a classification. The IRS will use the information entered on this form to establish the entity's filing and reporting requirements for Federal tax purposes.

Default Rules

Existing entity default rule.— Certain domestic and foreign entities that are already in existence before January 1, 1997, and have an established Federal tax classification, generally do not need to make an election to continue that classification. However, for an eligible entity with a single owner that claimed to be a partnership under the law in effect before January 1, 1997, that entity will now be disregarded as an entity separate from its owner. If an existing entity decides to change its classification, it may do so subject to the rules in Regulations section 301.7701-3(c)(1)(iv). A foreign eligible entity is treated as being in existence prior to the effective date of this section only if the entity's classification is relevant at any time during the 60 months prior to January 1, 1997.

Domestic default rule.—Unless an election is made on Form 8832, a domestic eligible entity is:

1. A partnership if it has two or more members.

2. Disregarded as an entity separate from its owner if it has a single owner.

Foreign default rule.—Unless an election is made on Form 8832, a foreign eligible entity is:

1. A partnership if it has two or more members and at least one member does not have limited liability.

2. An association if all members have limited liability.

3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Definitions

Business entity.—A business entity is any entity recognized for Federal tax purposes that is not properly classified as a trust under Regulations section 301.7701-4 or otherwise subject to special treatment under the Code. See Regulations section 301.7701-2(a).

Corporation.—For Federal tax purposes, a corporation is any of the following:

1. A business entity organized under a Federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.

2. An association (as determined under Regulations section 301.7701-3).

3. A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association.

4. An insurance company.

5. A state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar Federal statute.

6. A business entity wholly owned by a state or any political subdivision thereof.

7. A business entity that is taxable as a corporation under a provision of the Code other than section 7701(a)(3).

8. A foreign business entity listed in Regulations section 301.7701-2(b)(8). However, a foreign business entity listed in those regulations generally will not be treated as a corporation if all of the following apply:

a. The entity was in existence on May 8, 1996.

b. The entity's classification was relevant (as defined below) on May 8, 1996.

c. No person (including the entity) for whom the entity's classification was relevant on May 8, 1996, treats the entity as a corporation for purposes of filing that person's Federal income tax returns, information returns, and withholding documents for the tax year including May 8, 1996.

d. Any change in the entity's claimed classification within the 60 months prior to May 8, 1996, was a result of a change in the organizational documents of the entity, and the entity and all members of the entity recognized the Federal tax consequences of any change in the entity's classification within the 60 months prior to May 8, 1996.

e. The entity had a reasonable basis (within the meaning of section 6662) for treating the entity as other than a corporation on May 8, 1996.

f. Neither the entity nor any member was notified in writing on or before May 8, 1996, that the classification of the entity was under examination (in which case the entity's classification will be determined in the examination).

Binding contract rule.—If a foreign business entity described in Regulations section 301.7701-2(b)(8)(i) is formed after May 8, 1996, under a written binding contract (including an accepted bid to develop a project) in effect on May 8, 1996, and all times thereafter, in which the parties agreed to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed, **8** on page 2 is applied by substituting the date of the entity's formation for May 8, 1996.

Eligible entity.—An eligible entity is a business entity that is not included in items **1** or **3** through **8** under the definition of corporation on page 2.

Limited liability.—A member of a foreign eligible entity has limited liability if the member has no personal liability for any debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law under which the entity is organized (and, if relevant, the entity's organizational documents). A member has personal liability if the creditors of the entity may seek satisfaction of all or any part of the debts or claims against the entity from the member as such. A member has personal liability even if the member makes an agreement under which another person (whether or not a member of the entity) assumes that liability or agrees to indemnify that member for that liability.

Partnership.—A partnership is a business entity that has **at least** two members and is not a corporation as defined on page 2.

Relevant.—A foreign eligible entity's classification is relevant when its classification affects the liability of any person for Federal tax or information purposes. The date the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a Federal tax return, information return, or statement for which the classification of the entity must be determined.

Effect of Election

The resulting tax consequences of a change in classification remain the same no matter how a change in entity classification is achieved. For example, if an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations.

Who Must File

File this form for an **eligible entity** that is one of the following:

- A domestic entity electing to be classified as an association taxable as a corporation.
- A domestic entity electing to change its current classification (even if it is currently classified under the default rule).
- A foreign entity that has more than one owner, all owners have limited liability, and it elects to be classified as a partnership.
- A foreign entity that has at least one owner without limited liability, and it elects to be classified as an association taxable as a corporation.
- A foreign entity with a single owner having limited liability, and it elects to have the entity disregarded as an entity separate from its owner.
- A foreign entity electing to change its current classification (even if it is currently classified under the default rule).

Do not file this form for an eligible entity that is:

- Tax-exempt under section 501(a), or
- A real estate investment trust (REIT), as defined in section 856.

When To File

See the instructions for line 3.

Where To File

File Form 8832 with the Internal Revenue Service Center, Philadelphia, PA 19255. Also attach a copy of Form 8832 to the entity's Federal income tax or information return for the tax year of the election. If the entity is not required to file a return for that year, a copy of its Form 8832 must be attached to the Federal income tax or information returns of all direct or indirect owners of the entity for the tax year of the owner that includes the date on which the election took effect. Although failure to attach a copy will not invalidate an otherwise valid election, each member of the entity is required to file returns that are consistent with the entity's election. In addition, penalties may be assessed against persons who are required to, but who do not, attach Form 8832 to their returns. Other penalties may apply for filing Federal income tax or information returns inconsistent with the entity's election.

Specific Instructions

Employer Identification Number (EIN)

Show the correct EIN on Form 8832. If the entity does not have an EIN, it generally must apply for one on **Form SS-4,** Application for Employer Identification Number. If the filing of Form 8832 is the only reason the entity is applying for an EIN, check the "Other" box on line 9 of Form SS-4 and write "Form 8832" to the right of that box. If the entity has not received an EIN by the time Form 8832 is due, write "Applied for" in the space for the EIN. **Do not** apply for a new EIN for an existing entity that is changing its classification. If you are electing to disregard an entity as separate from its owner, enter the owner's EIN.

Address

Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the entity has a P.O. box, show the box number instead of the street address.

Line 1

Check box 1a if the entity is choosing a classification for the first time **and** the entity does not want to be classified under the applicable default classification. **Do not** file this form if the entity wants to be classified under the default rules.

Check box 1b if the entity is changing its current classification to take effect later than January 1, 1997, whether or not the entity's current classification is the default classification. However, once an eligible entity makes an election to change its classification (other than an election made by an existing entity to change its classification as of January 1, 1997), the entity cannot change its classification by election again during the 60 months after the effective date of the election. However, the IRS may permit (by private letter ruling) the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity as of the effective date of the election are owned by persons that did not own any interests in the entity on the effective date of the entity's prior election.

Line 2

Check the appropriate box if you are changing a current classification (no matter how achieved), or are electing out of a default classification. **Do not** file this form if you fall within a default classification that is the desired classification for the new entity.

Line 3

Generally, the election will take effect on the date you enter on line 3 of this form or on the date filed if no date is entered on line 3. However, an election specifying an entity's classification for Federal tax purposes can take effect no more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date on which the election is filed. If line 3 shows a date more than 75 days prior to the date on which the election is filed, the election will take effect 75 days before the date it is filed. If line 3 shows an effective date more than 12 months from the filing date, the election will take effect 12 months after the date the election was filed.

Regardless of the date filed, an election will in no event take effect before January 1, 1997.

Consent Statement and Signatures

Form 8832 must be signed by:

1. Each member of the electing entity who is an owner at the time the election is filed; or

2. Any officer, manager, or member of the electing entity who is authorized (under local law or the organizational documents) to make the election and who represents to having such authorization under penalties of perjury.

If an election is to be effective for any period prior to the time it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must also sign.

If you need a continuation sheet or use a separate consent statement, attach it to Form 8832. The separate consent statement must contain the same information as shown on Form 8832.

Observation. Many limited liability companies are established in order to give the owners protection from business debts (in the same manner as shareholders in a corporation), but also to attain partnership tax status for the entity. Thus, there should be few situations in which a domestic organization elects out of its default status. **For example, a domestic limited liability company that elects out of its default status would become a corporation. This would be advisable only in unusual situations.** The IRS has held that a limited liability company that elects to be a corporation for tax purposes can be an S corporation if it meets all of the S corporation eligibility requirements.

The new rules will apply to classifications after 1996 [**Reg.** §301.7701-3(e)(1)]. Thus, these rules do not completely protect existing organizations that have not received a ruling on their tax status. **However, the IRS has announced that it will respect the chosen classification before the effective date if the organization had a reasonable basis for claiming its tax status, and had used the same classification consistently** [**Treas. Reg.** §301.7701-3(e)(2)].

Caution. Reg. §301.7701-3 deals only with the federal tax treatment of limited liability companies, and has no impact on the state and local issues. Each prospective business that anticipates the possibility of only one owner should carefully examine the impact of state law. Some states do not permit a single-member limited liability company, whereas others allow this business form. It may be that many limited liability companies will be formed in states that permit a single member, and will do business as foreign limited liability companies in states that do not permit organization of a single-member limited liability company. The *Farm Income Tax Book* cannot give complete legal guidance on this issue, which may be more important to the business owners than the tax consequences. Thus, the owners, or prospective owners, of a closely held business should always consult competent legal counsel for guidance on this issue.

Self-Employment Income of a Partner

General Partners

Most income and loss allocated to general partners is treated as self-employment income. It is combined with any self-employment income from a proprietorship or farm and is subject to the self-employment tax on the individual's Form 1040.

There are exceptions for certain types of partnership income. Types of income that would not be treated as self-employment income if received directly by the partner include the following:

- Real property rents (unless services are significant) [I.R.C. §1402(a)(1), **Bobo,** 70 T.C. 706 (1978)]. Note that the IRS now instructs individuals to treat personal property rentals as self-employment income.
- Dividends and interest [I.R.C. §1402(a)(2)].
- Capital gains and losses.
- Gains and losses from the sale of other property, except for property held for sale in the ordinary course of business [I.R.C. §1402(a)(3)].

This treatment extends to both profit allocations and guaranteed payments [I.R.C. §1402(a), **Treas. Reg.**

§1.1402(a)-1(b)]. Thus a guaranteed payment can affect the allocation of self-employment income among the partners.

Example 1. The ABR partnership has three partners: Al, Bob, and Ruth. The partnership agreement provides Al with a guaranteed payment of $30,000 per year. Otherwise, the three partners share all items of income and loss equally. In the current year the partnership has $18,000 ordinary income from its principal trade or business, and also has $42,000 from interest and dividends, before deducting the guaranteed payment to Al. The allocation of self-employment income would be:

	Al	Bob	Ruth
Before guaranteed payment	$ 6,000	$ 6,000	$ 6,000
Guaranteed payment to Al	30,000	0	0
Guaranteed payment deduction	(10,000)	(10,000)	(10,000)
Net	$26,000	($4,000)	($4,000)

Limited Partners

In contrast to the general partner rules, **a limited partner's share of partnership income is not self-employment income.** If a limited partner receives a guaranteed payment for services performed to the partnership, the guaranteed payment **is self-employment income** [I.R.C. §1402(a)(13)].

Example 2. Larry, Debbie, and Fred are partners in the LDF limited partnership. Larry is the general partner, and Debbie and Fred are both limited partners. All profits, losses, and other items are divided equally among the three. The partnership earns $120,000 from an active trade or business in the current year. Larry would report $40,000 of ordinary income and self-employment income. Debbie and Fred would each report $40,000 of ordinary income but no self-employment income.

Retired Partners

In certain cases, payments to a retired partner are not self-employment income [I.R.C. §1402(a)(10)]. **The payments must meet all of the following conditions** [**Treas. Reg.** §1.1402(a)-17].

1. There must be a written plan for the payments.
2. The payments must continue until the partner's death.
3. The partner must perform no services for the partnership in the year in which the payments are received.
4. No other partner may have an obligation to make the payment.
5. The partner's interest in partnership capital must have been completely repaid by the close of the partnership's taxable year.

Members of Limited Liability Companies

Members of limited liability companies have not easily fallen within the definition of a limited partner or a general partner. Usually, these members all have the liability shield equivalent to that of a limited partner. They may or may not act like general partners with respect to other aspects of the business,such as the ability to contract on behalf of the organization, or management rights with respect to all activities of the business. If a person does have these powers, his or her role may resemble that of a general partner. A person who lacks these attributes may have a role similar to that of a limited partner.

The IRS has had some difficulty with this. In 1994, proposed regulations would have relied on state law characteristics to determine the general partner or limited partner equivalence. In 1997, however, the old proposed regulations were withdrawn and replaced by new proposed regulations. The following discussion is based on proposed amendments to **Treas. Reg.** §1.1402(a)-2, released on January 13, 1997.

The new amendments to the regulations will not provide a separate categorization scheme for members of limited liability companies per se. Instead, the IRS will adopt new definitions for all partnerships, including limited liability companies. Thus the title of the person under state law or the operating agreement will not be determinative. **A member of a limited liability company may be a "general partner," who is subject to the self-employment tax, or a "limited partner," who is not subject to the self-employment tax.**

The new rules will be uniform among the states and will not rely on state law definitions. **Under the new rules, a partner in a partnership, or a member of a limited liability company, will be treated as a limited partner unless that person meets any one of three conditions:**

1. He or she has **unlimited personal liability** for the company's debts, by virtue of being a partner [**Prop. Reg.** §1.1402(a)-2(h)(2)(i)]. This situation should rarely, if ever, arise for a member of a limited liability company.
2. **He or she has authority under the law to contract on behalf of the organization** [**Prop. Reg.** §1.1402(a)-2(h)(2)(ii)]. This condition may be conferred by state law or by the operating agreement adopted by the members. **It is likely to occur in many limited liability companies.**
3. He or she participates in the trade or business activities of the company for more than 500 hours in the taxable year under question [**Prop. Reg.** §1.1402(a)-2(h)(2)(iii)]. **Obviously, this condition will apply to certain persons and not to others.**

There are certain exceptions within the rules. For example, any member of a partnership or limited liability company that provides services as the predominant part of its trade or business is treated as a general partner, and will thus be subject to the self-employment tax. [**Prop. Reg.** §1.1402(a)-2(h)(5)]. **Thus, any member of a law firm, accounting firm, etc. will be subject to the self-employment tax on his or her portion of the income from the business.**

There are also special rules for fragmenting interests when a person holds both a limited and a general interest in the same partnership. **Note that this situation is unlikely for a limited liability company,** unless it is a syndicated investment company.

Practitioner Caution. In the 1997 Taxpayer Relief Act, the Senate expressed its displeasure with the proposed regulations defining limited partners. It stated that this task should be accomplished by the legislature. The conference committee directed the IRS not to issue any temporary official regulations on this matter before July 1, 1998 (§734 of the Senate amendment to H.R. 2014). **Thus it appears that the matter will remain in limbo for at least several more months.**

Conversion of an Existing Business to a Limited Liability Company

The conversion of an existing business was covered in considerable detail in the 1996 *Farm Income Tax Book*, in Chapter 13, pages 535–53. In general, the conversion itself involves a dissolution of the prior business form and creation of a new entity. The transfer of all of the assets from one business to another depends on both the prior business form and the new business form.

The following table illustrates the general rules. The prior form is shown in the left-hand column, and the tax classification is shown across the top.

	Tax Classification of Limited Liability Company	
Old Form	**Partnership**	**Corporation**
Partnership	Tax-free; new limited liability company is continuation of old partnership	Tax-free, unless control requirement of §351 was not met
Corporation	Taxable, both to corporation and shareholders	Tax-free, assuming tax-free reorganization

The explanation of these differing tax consequences is really quite simple.

- **Conversion of one partnership to another partnership** is generally tax-free, according to I.R.C. §708. A new partnership is treated as a continuation of the old partnership if holders of more than 50% of the new partnership were partners in the old partnership [I.R.C. §708(b)(2)(A)].
- **Incorporation of a partnership** (conversion to limited liability company where tax classification is corporation) is generally tax-free if the owners at time of conversion do not divest of their holdings. Classification of a limited liability company as a corporation will be an unusual case, advisable only in rare circumstances.
- **Conversion of a corporation to partnership status is a taxable liquidation.** These transactions received considerable discussion in the 1996 *Farm Income Tax Book* and receive some additional discussion below.
- **Reorganization of one corporation into another corporation is generally tax-free to both the shareholders and the corporations involved** (I.R.C. §§354, 361). Again, classification of a limited liability company as a corporation will be an unusual case, advisable only in rare circumstances.

liability company as a corporation will be an unusual case, advisable only in rare circumstances.

The conversion of an existing partnership is quite common, and the IRS has issued various letter rulings on the tax-free status of these conversions, even before the "check the box" regulation was promulgated. The rulings involved both general and limited partnerships that were converting to limited liability companies, where the limited liability company would be classified as a partnership for tax purposes. In these cases, the IRS held that the new limited liability company was a **continuation of the old partnership** (**Rev. Rul.** 95-37, 1995-1 **C.B.** 130; also see **PLR**s 9021019, 9010027, 9119029, 9538022, 602018, 9607006, 9602018, 9618022, 9618023, 9623016, 9633021, 9602018, 9538022).

Recently, there have been some mergers of preexisting businesses into limited liability companies. The merger is equivalent to the conversion from a corporation or partnership to a limited liability company and has the same tax consequences as those described above. When the old business is a partnership and the new limited liability company is treated as a partnership, the treatment is very simple and tax-free to all parties, absent unusual circumstances.

A merger of two partnerships is treated as a contribution of property to the surviving partnership by the members of the extinguished partnership in exchange for an interest in the surviving partnership. The extinguished partnership is simultaneously dissolved.

Example 3. Littleco, a general partnership, has two partners, Caroline and Richard. Littleco merges into Bigco, a limited liability company that has partnership tax status. The former partners of Littleco receive partnership interests in Bigco. Neither Littleco nor Bigco recognizes any gain or loss on the transaction; neither do Richard or Caroline.

Not surprisingly, there have been few rulings involving the conversion to limited liability company status when the limited liability company was treated as a corporation for tax purposes. In one of the few rulings on this point, when a corporation merged into a limited liability company and the limited liability company was treated as a partnership for tax purposes, the merger was treated as a **liquidation of the corporation** and the formation of a new partnership (**PLR** 9543017).

Note that the above ruling is consistent with what would have happened if the corporation had liquidated outright and the shareholders had contributed the assets received in liquidation to the new limited liability company.

By contrast, an S corporation merged into a limited liability company, and the limited liability company was classified as a corporation. The IRS held that the merger was a tax-free reorganization (**PLR** 9636007). Note that this transaction accomplished absolutely nothing from a tax point of view. In order to accomplish a tax-free merger of a corporation into a limited liability company, the limited liability company needs to be classified as a corporation for federal tax purposes.

Example 4. Oldco, a C corporation, merges into Newco, a limited liability company. The merger is governed by the law governing the state in which the two companies are located, and is completely in conformity with those laws. The shareholders of Oldco receive interests in Newco, and no other property. Oldco had a pre-merger basis in its assets of $1,000,000, which had fair market value of $2,000,000 on the date of the merger. The shareholders of Oldco had a total basis of $1,200,000 in their shares.

For tax purposes, the merger may have two possible treatments.

1. If Newco is classified as a partnership for federal income tax purposes, the merger will be treated as a **liquidation of Oldco.**
   - As a result of the liquidation, Oldco recognizes net gains of $1,000,000 on the distribution of property to its shareholders.
   - The corporation's tax liability from this distribution is $340,000.
   - Thus there is $1,680,000 ($2,000,000 predistribution assets less $340,000) to be distributed to the shareholders.
   - The shareholders then recognize gain or loss on the fair market value of the property treated as received from Oldco.
   - In this case the shareholders receive $1,680,000 in exchange for stock that had a basis of $1,200,000, for a gain of $480,000.
2. If Newco is classified as a corporation for tax purposes, the merger will most likely be a tax-free reorganization.
   - The former shareholders of Oldco will recognize no gain or loss on the transfer.
   - Oldco will recognize no gain or loss on the transfer of its assets to Newco of $1,000,000.
   - Newco will take a carryover basis from Oldco in each asset received.
   - The former shareholders of Oldco will take a carryover basis in their Newco shares of $1,200,000.

Termination of a Partnership

A partnership may terminate under local law upon the death, resignation, bankruptcy, or disability of any partner, unless the remaining partners agree to keep the business in place as a partnership. For tax purposes, however, a partnership is generally continued after one of these events. A partnership is terminated for tax purposes only when one of the following events occurs.

1. There is no continuing business or financial activity.
2. There are no longer two or more partners.

3. The partnership is merged into another partnership, and the partners of the former partnership do not own more than 50% of the surviving partnership.
4. There is a sale or exchange of 50% or more of the capital and profit interests in the partnership within a 12-month period.

The first could occur when a partnership **sells all of its assets.** The partnership would continue to exist for tax purposes during any winding down period, until the partnership had disposed of all of its remaining assets to its partners [**Treas. Reg.** §1.708-1(b)(1)(i)].

In the case of a two-person partnership, the partnership continues to exist for tax purposes after the resignation or death of one partner as long as the continuing business is making distributions to the retired partner, or to the deceased partner's successor in interest [**Treas. Reg.** §1.708-1(b)(1)(i)(b)]. Following the death of a partner in a two-person partnership, the partnership continues for federal income tax purposes as long as the estate or other successor in interest continues to share in partnership profits and losses [**Treas. Reg.** §1.708-1(b)(1)(i)(a)].

Example 5. Gilbert and Sullivan are partners in a two-person professional partnership. The operating agreement provides that if one of the partners dies, the company is obligated to purchase the decedent's interest from his estate at fair market value, date of death. Gilbert dies on August 3, 1997. His death immediately dissolves the partnership under local law, and Sullivan becomes the sole proprietor on the date of Gilbert's death. **For tax purposes, however, the partnership continues until the business has completed its purchase of Gilbert's interest from his estate.**

Practitioner Note.

The termination, at the time of sale of 50% or greater interest in profits and capital of the partnership, has recently been the subject of some controversy. **The IRS has recently issued new regulations dealing with this event, often known as a "technical termination."** Under the new regulations, the old partnership is treated as if it contributed all of its properties to a new partnership in a nonrecognition transaction, then distributed interests in the new partnership to the continuing partners.

Thus there is no triggering of any gain that might otherwise be required on the distribution of certain property, such as recently contributed property or recently acquired securities.

Observation. The American Bar Association, the American Institute of Certified Public Accountants, and other organizations are lobbying for the repeal of the technical termination rule. Thus practitioners should be alert to developments in this area of the law.

The termination of a partnership may have a number of unpleasant side effects. For example, if the prior partnership has been using a fiscal year, the new partnership will not necessarily be entitled to use the same year. None of the elections of the old partnership are considered to be in effect. This could cause some unexpected effects if the old partnership has been using LIFO and has accumulated a large reserve. Unless the new partnership makes a timely LIFO election for its first year, it may be treated as having disposed of its low-cost LIFO layer.

In general, a technical termination will not cause a partner to recognize gain, even if the partner's liabilities exceed his or her basis in the partnership interest.

Example 6. Realco, a general partnership, had five equal partners (both capital and profits interests) at the beginning of 1997: Allen, Brenda, Clyde, Darlene, and Earl. None of the partnership interests had changed hands in 1996. During 1997, some of the partners sold their interests to other persons, as follows:

Date	Selling Partner	Buying Partner
April 10	Allen	Leon
May 5	Brenda	Martha
November 5	Clyde	Norman

As of November 5, there had been 60% total interests sold within 12 months. Therefore, Realco is treated as if it were terminated for tax purposes on that date. Accordingly, pursuant to the regulations, the following transactions are deemed to occur, **in this order.**

1. The terminated partnership ("Old Realco") contributes all of its assets to a new partnership ("New Realco").
2. Old Realco then distributes out interests in New Realco to the partners, who are now Leon, Martha, Norman, Darlene, and Earl.
3. Old Realco and the partners do not recognize any gain or loss on the contribution of property to the new partnership (I.R.C. §721).
4. Old Realco and the partners do not recognize any gain or loss on the distribution of New Realco interests to the new partners (I.R.C. §731).

Treatment of Partnership Liabilities at Time of Termination

On the termination of a partnership, the former partners' shares of partnership liabilities may be altered. Thus there could be constructive cash contributions and cash distributions. This provision was discussed in earlier versions of the *Farm Income Tax Book,* but it bears some review at this point.

In general, the code allocates all partnership liabilities among the various partners. The mechanics of the allocation can become quite complicated. See the 1994 *Farm Income Tax Book,* pages 174–81, for a complete discussion and examples of the allocation. The most important aspects of I.R.C. §752 are the treatments of increases and decreases of a partner's share of partnership liabilities.

Code §752(a) treats an increase of a partner's share of liabilities as a contribution of cash.

STATUTORY AUTHORITY: CODE SECTION 752(a)

(a) Increase in Partner's Liabilities.¾Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Thus the partner whose share increases receives additional basis in his or her partnership interest. This phenomenon allows a partner to have positive basis and a negative capital account balance.

The increase can result from any or all of three events:

- The partnership may borrow additional money, and the partner's interest in the percentage of partnership liabilities does not change.
- The partnership debt level may remain constant, and the partner's portion of the debt changes.
- The partner may assume liabilities directly from the partnership. This may or may not be in connection with a distribution of property from the partnership, subject to liabilities.

A partner's decrease in partnership liabilities is treated as a distribution of cash.

STATUTORY AUTHORITY: CODE SECTION 752(b)

(b) Decrease in Partner's Liabilities.¾Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

A distribution of cash is generally treated as a reduction of the partner's basis. If the distribution exceeds the partner's basis, immediately prior to the distribution, the excess of the basis is**taxable** to the partner as a gain.

The decrease can result from any or all of three events:

- The partnership may repay debts, and the partner's interest does not change.
- The partnership debt level may remain constant, and the partner's portion of the debt changes.
- The partnership may assume liabilities directly from the partner. This may or may not be in connection with a contribution of property from the partnership, subject to liabilities.

When there is a reallocation of existing partnership liabilities among the partners, there can be some strange results. The partner or partners who are increasing their shares of liabilities will be treated as if they have contributed cash, and the partner or partners whose liabilities have decreased are treated as if they have received a distribution of cash. If any partner's liability decrease exceeds his or her basis, that partner will be required to report a **taxable gain** [I.R.C. §731(a)].

Thus, any time a partner relinquishes his or her interest in a partnership, and the partner had a share of partnership liabilities, there will be a constructive distribution of cash to that partner.

Observation. In the early 1990s, many real estate partnerships were caught in a series of compounding economic problems. Real estate partnerships had been desirable tax shelters through the mid 1980s. The availability of tax benefits had helped to drive up the cost of real estate investments. Lenders, especially savings and loan associations, had been willing to lend substantial nonrecourse funds to finance these projects. As a result, many areas in the United States experienced excess capacity of improved real estate.

After 1986, tax shelters, including real estate partnerships, could no longer offer the tax benefits they had been able to offer in the past. Therefore, their attractiveness, and accordingly their prices, declined. New investors were looking for real economic payoffs rather than tax benefits. The excess capacity in many parts of the country left purchasers in stronger bargaining positions. At the same time, the decline of real estate prices left many lenders with bad loans. When the loans were nonrecourse and the value of the subject property was insufficient to satisfy the debt, lenders' losses began to mount. Many lenders with large real estate holdings became insolvent and were absorbed by other institutions or governmental agencies. The lenders who survived this ordeal became much more conservative in their lending policies. The resultant tightening of money further contributed to the decline in real estate prices and thus the value of real estate partnerships.

In many tax shelter partnerships, the investor's basis includes his or her share of nonrecourse liabilities. These liabilities are allocated to all partners, including limited partners, in accordance with each partner's profit sharing ratio. Since many partnerships, especially those with substantial real estate investments, were highly leveraged, a large portion of each partner's basis was from partnership debt rather than the partner's capital contributions. **Due to the generous depreciation allowances in the early and middle 1980s, many partners were able to take deductions in excess of their capital contributions in the very early years of the partnership.** The depreciation typically occurred much faster than the amortization of partnership liabilities, so the partnership soon found that it had liabilities in excess of the basis of its properties. The partners similarly found themselves with "negative capital accounts."

The leverage and early write-offs provided immediate tax benefits. These benefits could **backfire,** however, with either of two events:

1. The partnership disposed of its property, or
2. The partner disposed of his or her interest.

In either case, the partner's liability relief, which was treated as cash received in a sale or distribution, could exceed the partner's basis and be taxed as a gain.

Example 7. Hifliers, a real estate partnership, was formed in 1983. It raised $1,000,000 in equity capital from 100 limited partners, who invested $10,000 each. It borrowed $19,000,000 on a nonrecourse basis and bought land and a building near Washington, DC. At the time of acquisition, the land had a value of $5,000,000 and the building had a value of $15,000,000. By the end of 1997, the partnership still owed $18,000,000 on the nonrecourse debt. Its cumulative cash flow had been a break even, and its accumulated depreciation had been $9,000,000.

At the beginning of the partnership, each partner had a basis in his or her partnership interest of $200,000 ($10,000 plus $190,000 in allocated liabilities). By the end of 1997, each partner had been allocated $90,000 of depreciation, which had reduced the basis to $110,000.

The next two examples illustrate the effects of a foreclosure of property from a leveraged partnership, or the abandonment or gift of a partnership interest. First, we consider the case of a foreclosure.

Example 8. Refer to **Example 7.** In the early years the land had risen rapidly in value. Beginning in 1989, however, the value of the land and building began to diminish. At the end of 1997 the land and building were worth $14,000,000 in total. At the end of 1997, the partnership was no longer able to make payments on the note, and the lender repossessed the property.

At the time of repossession the mortgage balance of $18,000,000 exceeded the property's adjusted basis of $11,000,000 (original cost of $20,000,000 less $9,000,000 in depreciation). The foreclosure resulted in a gain of $7,000,000 to the partnership. Each of the 100 partners would be allocated $70,000 of the gain, which would be included in each person's 1997 taxable income.

Abandonment of a Partnership Interest

The **abandonment or gift of a partnership interest could have similar results for a partner as would a foreclosure of partnership property.** Section 752(d) would require each partner to treat his or her portion of partnership liabilities as cash paid on the transfer.

STATUTORY AUTHORITY: CODE SECTION 752(d)

> *(d) Sale or Exchange of Interest.¾In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.*

The portion of the selling partner's liabilities that are taken over by the purchaser are treated as additional cash paid by the purchaser.

- If the partnership debts are **nonrecourse liability,** the selling partner is treated as if the liability were **discharged** [**Treas. Reg.** §1.1001-2(a)(4)(i)].
- If the liability is a **recourse** liability, it is not necessary that the seller be released from all legal obligation [**Treas. Reg.** §1.1001-2(a)(4)(ii)].

Example 9. Refer to **Example 8.** Assume the same facts, except that the partnership is still solvent at the end of 1997, so the lender does not foreclose on the property. Some of the partners, however, are experiencing financial distress. The partnership agrees to allow some of the partners to abandon their partnership interest. Each partner would abandon an asset with a basis of $110,000. Each partner would be treated as having received $180,000 in cash due to the relief from partnership debt. Thus the abandonment of a partnership interest would create a **paper gain of $70,000.**

Effect of Unrealized Receivables and Inventory Items

Code §751(a) treats a partner's share of these assets (also known as "hot assets") as an asset sold separately from the rest of the partnership interest. The sale of these items can only result in ordinary income. Discussion of this issue was included in the 1995 *Farm Income Tax Book.* **The Taxpayer Relief Act of 1997 made a slight modification to this rule, so it is revisited briefly in this edition.**

STATUTORY AUTHORITY: CODE SECTION 751(a)

(a) Sale or Exchange of Interest in Partnership.¾The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to¾

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

Unrealized receivables include:

- Any rights to payment for goods or services delivered (or performed) or to be delivered (or performed), but only if:
  - The income has not been reported, and
  - The income that will be reported is not a capital or §1231 gain.
- An account receivable of an accrual basis partnership is not an unrealized receivable.
- A note receivable, with full basis, is not an unrealized receivable, even if the partnership uses the cash method of accounting.

Unrealized receivables also include depreciation recapture under Code §1245 or §1250.

- Depreciable assets must be dually classified:
  1. The amount that would be recognized as depreciation recapture if the partnership were to dispose of the property at its fair market value in a taxable transaction **is an unrealized**

2. The amount that would be reported as recovery of basis if the partnership were to dispose of the property at its fair market value in a taxable transaction **is *not* an unrealized receivable.**
3. The amount that would be reported as gain in excess of depreciation recapture (§1231 gain) if the partnership were to dispose of the property at its fair market value in a taxable transaction **is *not* an unrealized receivable.**

The term "unrealized receivables" includes any depreciation recapture under Code §1245 or §1250. Recapture under Code §1245, which primarily covers personal property, is applied to gain realized, to the extent of all depreciation.

Example 10. Allen is selling his one-quarter interest in the FITS partnership. The partnership has an item of §1245 property that originally cost $1,000,000 and has been depreciated down to an adjusted basis of $300,000. The fair market value of the property on the date that Allen sells his interest is $700,000. Thus Allen will treat $100,000 of the sale price of his partnership interest as sale of an unrealized receivable (one-quarter of the depreciation recapture that would have been reported by the partnership if the partnership had sold the asset for its fair market value).

Special Application of New Law to Real Estate Partnerships

The amount of depreciation recapture from the sale of most real estate is limited to the excess of the depreciation claimed on the property over the amount that would have been allowed if the property had been depreciated using the straight-line method [I.R.C. §1250(a)]. Since 1987, only the straight-line method has been allowed for real estate [I.R.C. §168(b)(3)(A)]. Therefore, there is no recapture under §1250 on any property placed in service after 1986. On much of the real property placed in service before 1987, the straight-line depreciation is beginning to catch up with the declining balance method, so that the recapture under §1250 is rapidly diminishing. In the near future, this recapture will all but disappear and will be present only with extremely long-lived assets placed in service before 1981.

To make matters more confusing, the Taxpayer Relief Act of 1997 adds a new term to characterize certain gains on the disposition of depreciable real estate. The term "unrecaptured §1250 gain" deals with a certain portion of the gain on the disposition of real estate. This gain is not the same as, and cannot even include, any gain treated as ordinary income under the recapture provision of §1250. It is defined as gain that would be treated as ordinary income if §1245 rules applied to the property, but is not otherwise recaptured under §1250 [**I.R.C. §1(h)(6), after amendment by the Taxpayer Relief Act of 1997**].

From a careful reading of the definition, unrecaptured §1250 gain is any gain from the sale of depreciated real estate that does not exceed the depreciation allowed on the property before its sale. The significance of this provision is that the tax on this type of gain is 25%, as opposed to the 20% rate on some long-term capital gains and the 28% rate imposed on other capital gains.

Although the law does not specifically provide that a sale of the partnership interest shall be treated as unrecaptured §1250 gain, if the partnership holds depreciated real property, the law specifically grants regulatory authority to the IRS to make this determination [I.R.C. §§1(h)(11), **as amended by the Taxpayer Relief Act of 1997**].

Example 11. Allen is selling his one-quarter interest in the FITS partnership. He has held the partnership interest longer than 18 months. FITS has no unrealized receivables or inventory items. The partnership has an item of §1250 property that originally cost $1,000,000 and has been depreciated down to an adjusted basis of $300,000, using the straight-line method. The fair market value of the property on the date that Allen sells his interest is $700,000. Thus Allen will not treat any of his gain on the sale of the partnership interest as ordinary income, because §1245 does not apply to §1250 property (generally buildings and structural components thereof). If the sale is after May 6, 1997, however, the IRS may require Allen to treat a portion of his gain as unrecaptured §1250 gain, which is subject to a tax of 25% rather than 20%.

Unrealized receivables also include some ordinary income items from several properties, which vary in importance depending on the business operations [I.R.C. §751(c)]:

- Mining property [as defined in §617(f)(2)]
- Stock in a DISC [as described in §992(a)]
- Stock in certain foreign corporations (as described in §1248)
- Farm land [as defined in §1252(a)]
- Franchises, trademarks, or trade names [referred to in §1253(a)]
- Oil, gas, or geothermal property (described in §1254)

The above properties represent unrealized receivables only to the extent that any gain from their disposition by the partnership at fair market value would result in ordinary income under the specific governing code sections.

Inventory Items Defined. Inventory items include any asset that would result in ordinary income if the partnership disposed of the asset in a taxable transaction at its fair market value [I.R.C. §751(d)]. These assets include all unrealized receivables. Thus there is a double counting of unrealized receivables. This awkward structure of the law does not cause any partnership asset to be sold twice, however.

Prior to amendment by the **Taxpayer Relief Act of 1997,** the rule treating a portion of a selling partner's gain as ordinary income applied to inventory items of the partnership only if they had appreciated substantially in value—which meant that the fair market value of these assets needed to exceed 120% of their aggregate adjusted basis. **This rule is repealed for sales of partnership interests with the enactment of the Taxpayer Relief Act of 1997** [Taxpayer Relief Act of 1997, §1062(c)(1)]. There is an exception for sales subject to binding contracts that were in existence on June 8, 1997 [Taxpayer Relief Act of 1997, §1062(c)(2)].

> **Note:** for purposes of disproportionate distributions, which alter a partner's share of unrealized receivables and inventory items, there remains a requirement that the inventory items must be substantially appreciated in value, as under prior law.

Electing Out of Partnership Status

Ordinarily, an unincorporated organization is treated as a partnership. This rule is sufficiently broad to treat joint ventures as partnerships [see ***Madison Gas and Electric Company,*** 72 T.C. 521, 1979]. In some cases, individual owners may prefer to treat jointly owned property as not being a partnership. For instance, a co-owner may dispose of an interest in property in a like-kind exchange, which is not permissible with an interest in a partnership.

Example 12. Bob and Florence jointly purchase some unimproved real estate. If they treat the real estate as a partnership, neither partner may exchange his or her interest in a like-kind exchange. If they elect out of partnership status, either person may be able to exchange his or her interest for other real estate in a like-kind exchange.

Similarly, co-owners may make individual elections (depreciation, etc.) on their own portions of jointly held property.

Example 13. Three farmers buy a combine for a total cost of $60,000. Each farmer contributes $20,000. Each farmer uses the combine to harvest his own crops. The operation of the combine is not conducted as a business per se. If the farmers treat the venture as a partnership, they could claim a single §179 deduction for the year in which the combine is placed in service. If they elect out of partnership status, each owner could claim a separate §179 deduction.

An unincorporated organization may, under certain conditions, elect out of partnership status, and may be treated as a title holding device of its owners. If the organization makes this election, the owners may be entitled to the tax benefits illustrated in the last two examples. In addition, the business need not file returns (except for the first year of existence, as is discussed below).

Treas. Reg. §1.761-2 provides means for electing out of partnership status. There are certain requirements that must be met:

1. The property must be held for mere investment purposes, and not for the conduct of an active trade or business [**Treas. Reg.** §1.761-2(a)(1)(i)]. Under this arrangement, the investors own the property as co-owners [**Treas. Reg.** §1.761-2(a)(2)(i)]. Each investor retains the right to dispose of his or her interest [**Treas. Reg.** §1.761-2(a)(2)(ii)].
2. Alternatively, the property may be held for joint production, extraction, or use of the owners [**Treas. Reg.** §1.761-2(a)(1)(ii)]. Under this arrangement, they own the property as co-owners [**Treas. Reg.** §1.761-2(a)(3)(i)]. Each investor retains the right to dispose of his or her interest [**Treas. Reg.** §1.761-2(a)(3)(ii)]. In addition, the investors do not jointly sell services or property from the venture [**Treas. Reg.** §1.761-2(a)(3)(iii)].
3. The activity does not need to keep its own books in order for the owners to determine taxable income from the property [**Treas. Reg.** §1.761-2(a)(1)].

The **procedural aspects** of the election are relatively simple. For the first year of the arrangement, the owners should file a joint Form 1065, which clearly identifies the property.

1. The Form 1065 contains no information except for the statement that the owners are electing out

of partnership status pursuant to **Treas. Reg.** §1.761-2. There is no need for any Schedule K or K-1.

2. In subsequent years, the entity files no information return.
3. In each year, including the first year, the owners report their shares of income and deduction on their personal or business tax returns.

Method of Accounting

In general, a partnership is allowed to use the cash method of accounting, unless it meets one of**three exceptions:**

1. A partnership must use the accrual method if it has a C corporation (other than a personal service corporation) as a partner.
2. If the partnership is engaged in a business that involves production or sale of goods, it will be required to take its beginning and ending inventories into account in determining taxable income [**Treas. Reg.** §1.446-1(a)(i)].
3. A partnership must use the accrual method if it is a tax shelter, in which at least 35% of the losses are allocated to limited entrepreneurs [I.R.C. §461(i)(3), §448(d)(3)].

The code does not define a limited entrepreneur. It may be possible that a member in a limited liability company could be treated as a limited entrepreneur, due to the liability protection under state law. As a result, several limited liability companies have requested rulings that they not be treated as tax shelters, and be allowed to use the cash method. The IRS has ruled **favorably** in the cases of several professional firms, and held that they are not tax shelters (**PLRs** 9350013, 9407030, 9415005, 9637030, 9623016, 9602018). There are two lines of reasoning:

1. The businesses **do not anticipate** the generation of tax losses.
2. The owners have unlimited participation in management, and thus are not limited entrepreneurs.

Practitioner Note.

The IRS has been adamant in its efforts to convert more taxpayers to the accrual method of accounting. Consistent with this philosophy, sometimes the IRS refuses to rule on a partnership's entitlement to use cash method. (See PLR 9538022, in which the partnership was in the practice of law.) **The IRS, however, ruled that the change from a general partnership to a limited liability company would not affect the entitlement to use the cash method, per se.**

Example 1. Al and Bob have been operating their tax practice as a general partnership. They decide to change the business form to limited liability company. They have been using the cash method of accounting. The IRS is likely to rule that the change of the business form to limited liability company **will not change the ability of the business** to use the cash method of accounting. The IRS national office, however, may decline to give outright permission for the firm to use the cash method, in case the district director might examine this issue.

Partnerships and Business Automobiles

As is the case with any owner of an automobile, a partnership must meet all of the requirements to deduct depreciation and other expenses with respect to company-owned automobiles. As is the case with any other business, a partnership is susceptible to examination and adjustment if there is personal use of a partnership automobile by a partner. As is discussed in this year's Corporation chapter of the *Farm Income Tax Book,* the IRS has two means by which to disallow the partnership a deduction for personal expenses. **First,** it may merely disallow the expenses as not being incurred in a trade or business under Code §162. **Second,** it can disallow expenses that are personal in nature under Code §262.

Planning Strategies. If a partnership incurs expenses in connection with a partner's personal use of a partnership automobile, it should reclassify those expenses as a guaranteed payment and claim a deduction under I.R.C. §707(c). The partner who receives the benefit of the personal use of the automobile will be required to report the guaranteed payment on his or her 1040. This method of reporting shifts the nondeductibility of the expenses to the person who receives the benefit, and away from the partnership in general.

1997 Changes To Partnership Distribution Rules

In general, neither the partnership nor any partner recognizes any gain or loss on the distribution of property from the partnership to a partner. As past issues of the *Farm Income Tax Book* have discussed, the distribution rules represent some of the principal advantages of the partnership (including the limited liability company) from a tax point of view. There are some exceptions to the nonrecognition rules that require recognition of income or gain, or permit recognition of loss.

Until recently there were only three exceptions:

- If cash distributed exceeds the partner's predistribution basis, gain is recognized to the extent of the excess [I.R.C. §731(a)(1)].
- If a partner receives only cash, receivables, and inventory items (or any combination thereof), and no other property, in a liquidating distribution, and the total basis of the property received is less than the partner's predistribution basis, the partner recognizes capital loss [I.R.C. §731(a)(2), §741].
- A distribution that alters a partner's interest in **hot assets** (also known as §751 property, also known as

inventory items and unrealized receivables) may be treated in part as a taxable sale. See the 1995 *Farm Income Tax Book.*

These rules allowed some unique planning opportunities, by which the partnership could be used to structure some tax-free or tax-deferred exchanges. **The IRS had long held that a contribution of property followed by an immediate distribution was tantamount to a sale** (**Rev. Rul.** 57-200, 1957-1 C.B. 205). However, the statute did not cover specific situations. Therefore, several changes to the code over the last several years have tended to **limit** the nonrecognition rule. **Exceptions to date include the following:**

- If a partner contributes property to a partnership and receives a distribution from the partnership, and the contribution and distribution are part of the same integrated transaction, the two transactions are treated as a disguised sale under I.R.C. §707(a). In 1992 the IRS issued regulations under §707(a) that generally provide that a contribution and distribution are part of an integrated transaction if the two transactions occur within two years of each other. The applications become quite complicated, due to some important exceptions.
- If a partner contributes property to a partnership and the partnership distributes the same property to another partner within seven years of the contribution, the contributing partner reports gain as if the property had been sold [I.R.C. §704(c)(1)(B)]. **The Taxpayer Relief Act of 1997 changed the period of recognition from five to seven years.**
- If a partner contributes property to a partnership, and the same partner receives noncash property as a distribution from the partnership within seven years of the contribution, the partner recognizes gain as if the property contributed to the partnership had been sold to the partnership [I.R.C. §737]. **The Taxpayer Relief Act of 1997 changed the period of recognition from five to seven years** [Taxpayer Relief Act of 1997 §1063(a)]. **The rule is effective for property contributed to a partnership after June 8, 1997,** with an exception for property contributed pursuant to a binding contract that was in effect on June 8, 1997, and at all times thereafter [Taxpayer Relief Act of 1997 §1063(b)].

Example 2. George owned equipment with a fair market value of $250,000 and adjusted basis of $10,000. HJ Partnership owned real estate with a fair market value of $250,000 and adjusted basis of $10,000. HJ had additional assets with a fair market value of $250,000. George contributed his equipment to HJ in exchange for a one-third interest therein. Under the general distribution rules, before changes made in 1989 and 1992, one or both of the following could happen without recognition of gain by George, the partnership, or any other partner:

1. George could receive the real estate as a distribution from the partnership. He would merely take a carryover basis from the partnership in the real estate.
2. The partnership could distribute the equipment contributed by George to another partner. The receiving partner would not recognize gain or loss, the partnership would not recognize gain or loss, and George would not recognize gain or loss. The receiving partner would take a carryover basis in the property received

Thus it was possible to use the partnership contribution and distribution rules to effect indirect like-kind exchanges among the partnership and the various partners. **As a result of recent changes, however, the**

opportunities are much more limited.

Example 3. Refer to **Example 2.** Under current law, the following rules could affect the taxation to George and the partnership:

1. If George received a distribution within two years of the contribution of property, the contribution could be taxable to George as a disguised sale. There are some mechanical tests and some subjective tests that might affect the tax treatment. For instance, if there were clear and convincing evidence that the distribution was not related to the contribution of property, the distribution might be tax-free.
2. If another partner received the property contributed by George within seven years (five years, prior to the 1997 changes), George would recognize gain at the time of the distribution to the other partner, as if the property had been sold at its fair market value (at the time George contributed the property to the partnership).
3. If the partnership retained the property contributed by George, but George received other partnership property within seven years, George would recognize gain at the time of the distribution, as if the partnership had sold the contributed property at its fair market value (at the time George contributed the property to the partnership).

Under current law Code §704(c)(1)(B) requires George to recognize gain when GH distributed the equipment to Helen, to the extent of his precontribution gain. Helen would likewise recognize gain when GH distributed the real estate to George.

- This rule applies where the property was contributed to the partnership after October 3, 1989 [PL 101-239, §7642(a)].

Basis in Property Distributed from a Partnership to a Partner

When a partner receives property in a liquidating distribution, and the property is not cash, a receivable, or an inventory item, the partner assigns the assets received a basis equal to the partner's predistribution basis in the partnership interest (the substituted basis rule) [§732(c)]. Prior to amendment by the Taxpayer Relief Act of 1997, the basis assigned to these assets was in proportion to their adjusted basis to the partnership, immediately prior to the distribution.

Example 4 (Adapted from the Committee Reports to the Taxpayer Relief Act of 1997). A partnership with two assets, A and B, distributes them both in liquidation to a partner whose basis in its interest is 75. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of 5 and a fair market value of 40, and asset B has a basis to the partnership of 10 and a fair market value of 10.

Prior to the Taxpayer Relief Act of 1997 the partner would allocate basis as follows:

	Partnership Predistribution	*Partner Predistribution*	
Asset	**Basis**	**Percent**	**Basis**
A	5	1/3	25
B	10	2/3	50
Total			75

An immediate sale of both assets at fair market value would result in a gain of $15 ($40 - $25) on asset A and a loss of $40 ($50 - $10) on Asset B.

The Taxpayer Relief Act of 1997 changed the rule so that postdistribution basis is allocated by means of a three-step process:

1. **First,** carry the individual asset basis over to the partner.
2. **Second,** allocate in accordance with appreciation (or depreciation) of the assets in the hands of the partnership, up to the fair market value of the assets.
3. **Third,** any remaining predistribution basis is allocated in accordance with the fair market value of each asset.

This rule is effective for distributions after enactment of the Taxpayer Relief Act of 1997 (August 5, 1997) [Taxpayer Relief Act of 1997 §1061(b)].

Example 5. Refer to **Example 4.** If the distribution occurs after August 5, 1997, the allocation of basis would be:

Step 1			
Asset			**Basis**
A			5
B			10
Total			15
Remaining basis to be allocated (75 – 15)			60
Step 2			
Asset	**Basis**	**FMV**	**Appreciation**
A	5	40	35
B	10	10	0
Total			35
Remaining basis to be allocated (60 – 35)			25
Step 3			
Asset	**FMV**	**Percent**	**Basis**
A	40	80	20
B	10	20	5

Total			25
Total Basis Allocation		**Asset A**	**Asset B**
Step 1		5	10
Step 2		35	0
Step 3		20	5
Total		60	15

The new rules are more complicated than the old ones. In perspective, however, they are more consistent with basis allocations required following a §754 adjustment due to a distribution of partnership property. [See §734(b) and §755, as well as the regulations thereunder.]

In summary, the partnership provisions are generally desirable from a tax point of view. They are easier to attain for a limited liability company after 1996, due to the new classification ("check the box") regulation. There are special rules to be observed on the disposition of an interest in a partnership. The liability relief rule can provide for gains even when it appears that there are economic losses. The rules regarding unrealized receivables and inventory items may cause a selling partner to report ordinary income on the disposition of an interest in a partnership. Finally, an organization that involves joint ownership, but does not constitute a trade or business in its own right, may elect out of partnership status.