LLCs AND PARTNERSHIPS

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INTRODUCTION

This chapter discusses tax issues for partnerships and limited liability companies (LLCs) that are taxed as partnerships. For clarity and ease of exposition, terms will be used as follows in this chapter.

- "Company" will be used to refer to either a partnership or LLC when the laws being discussed apply to both.
- "Owner" will be used to refer to either a partner of a partnership or a member of an LLC when the laws being discussed apply to both.

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LIMITED LIABILITY COMPANIES AND THE "CHECK THE BOX" ELECTION TO BE A CORPORATION

The Internal Revenue Code classifies businesses as sole proprietorships, partnerships, or corporations (associations) for purposes of federal income taxes. Accordingly, limited liability companies (LLCs) must be classified as one of those business entities to apply federal tax law to them.

BACKGROUND

In Rev. Rul. 88-76, 1988-2 C.B. 360, the IRS ruled that under I.R.C. §7701(a) and Treas. Reg. §301.7701-2, an LLC organized in Wyoming with 25 members would be taxed like a partnership since it had more than two of the following four corporate characteristics:

1. Centralization of management
2. Continuity of life
3. Free transferability of interests
4. Limited liability

By removing any doubt that an LLC could be taxed as a partnership, that ruling led to a landslide of state legislation authorizing LLCs as a form of doing business. By August 1996, all 50 states and the District of Columbia had provisions for the organization and registration of LLCs.

While Rev. Rul. 88-76 made it clear that under I.R.C. §7701(a) an LLC could be taxed as a partnership, the code and regulations left a lot of room for argument between taxpayers and the IRS on the issue of whether or not a particular LLC had more than two corporate characteristics. Some state laws were drafted to ensure that any LLC organized in the state would meet the federal tax requirements for being taxed as a partnership. Other states allowed flexibility in organizing an LLC, which made it possible to have more than two of the corporate characteristics and therefore fail the test for being taxed as a partnership.

Also in the mid-1990s, states began to amend their LLC statutes to allow one-member LLCs. These entities created a new federal tax issue since federal partnership tax law did not recognize partnerships with only one partner.

DEFAULT STATUS OF THE LIMITED LIABILITY COMPANY

To resolve the issue of classifying LLCs for federal income tax purposes, the Treasury issued final regulations that were effective January 1, 1997 [Treas. Regs §301.7701-3]. This "check the box" regulation sets out a default tax status for LLCs and allows the members of the LLC to elect out of the default status. The default status depends on two factors:

1. Whether the LLC has only one or more than one member
2. Whether the LLC was organized in the United States or a foreign country

The default and elective status of LLCs are as follows:

1. A domestic LLC with two or more members is taxed as a partnership unless its members elect to have the LLC taxed as a corporation.
2. A domestic LLC with only one member is disregarded as an entity for federal income tax purposes unless its member elects to have the LLC taxed as a corporation. If the LLC is a disregarded entity and the member is an individual, the individual is treated as owning a sole proprietorship for federal income tax purposes. If the LLC is a disregarded entity and the member is a corporation or another business entity, the LLC is treated as a branch or division of the business entity.

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3. A foreign LLC is taxed as a corporation (assuming all the members have limited liability) unless the members elect to have the LLC taxed as a partnership.

SUBSEQUENT CHANGES IN ENTITY CLASSIFICATION

An unincorporated organization may change its classification after it is already in existence. Thus, a limited liability company that has been treated as a partnership (or disregarded entity) may elect to become a corporation for tax purposes. Similarly, an organization that has elected to be a corporation under the check-the-box regulation may change its classification to that of a partnership (or disregarded entity, if it has only one member at the time of the change).

The IRS has issued a proposed amendment to Treas. Reg. §301.7701-3 that deals specifically with changes in classification. The amendments are summarized in the following table.

Change from	Change to	Treatment	Citation
Partnership	Association (corporation)	The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners	Treas. Reg. §301.7701-3(g)(1)(i)
Association (corporation)	Partnership	The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership	Treas. Reg. §301.7701-3(g)(1)(ii)
Association corporation)	Disregarded entity	The association distributes all of its assets and liabilities to its single owner in liquidation of the association	Treas. Reg. §301.7701-3(g)(1)(iii)
Disregarded entity	Association (corporation)	The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association	Treas. Reg. §301.7701-3(g)(1)(iv)

POSSIBLE REASONS FOR ELECTING TO BE A CORPORATION

In the vast majority of situations, a limited liability company is best served by being a partnership or nonentity for tax purposes. However, there are some advantages to corporate treatment. They include:

1. The company has merged with a corporation and the corporation does not want to treat the merger as a taxable liquidation.
2. The members are concerned about self-employment tax ramifications of being in proprietorship or partnership form. As of mid-2001, the treatment of limited liability company income for purposes of self-employment tax rules is not entirely clear. The corporation (whether C or S) will not create self-employment income for any amounts it retains. However, any amounts actually distributed to shareholders may be characterized as compensation and thus be subject to FICA, FUTA, worker's compensation, and other federal and state assessments.
3. The company may be considering going public. When a partnership becomes publicly traded, it will be a de facto corporation for federal income tax purposes [I.R.C. §7704]. This change in form will be an incorporation under Prop. Reg. 301.7701-3. Since the historic owners will not be in control of the enterprise (within the meaning of I.R.C. §368(c)) the change in status will be treated as a taxable sale of the assets of the business by the existing partnership and will result in immediate gain to the members.

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4. The business may want to be a target for a takeover by a corporation. This takeover can be a tax-free reorganization only if the enterprise is already a corporation for federal tax purposes. Otherwise, the change in status will be a taxable event, under the same rationale as in reason 3 above.

ELIGIBILITY FOR S CORPORATION STATUS

A limited liability company can qualify for S corporation status, if it elects to be classified as a corporation for federal income tax purposes under Treas. Reg. §301.7701-3 [see Ltr. Rul. 9636007]. This permission extends to both the single member limited liability company and the LLC with more than one owner. The association must meet all of the other eligibility requirements in Subchapter S, and file a proper and timely S election [see I.R.C. §1361(b) for the requirements as to number and types of shareholders, classes of stock, and certain other requirements].

The limited liability company must file two elections to be treated as an S corporation:

1. The entity must first file Form 8832 within 75 days after the day that it wants to attain corporate status.
2. After (or concurrent with) Form 8832, the entity must file Form 2553 to attain S status.

Practitioner Note. Filing Form 2553 may require some explanations, depending on the local governance of limited liability companies. For example, Form 2553 requires a listing of ownership of "shares of stock." It may be necessary to attach a supplement to reconcile the "stock shares" with the various members' capital accounts.

FORMATION AND BASIS

FORMATIONS AND CONTRIBUTIONS OF PROPERTY

In general, contributions of appreciated or depreciated property to a partnership are not taxable events. These rules apply to a multiple member limited liability company unless the LLC has elected to be taxed as a corporation under the check the box regulation [Treas. Reg. §301.7701-3].

Contributions of Property

In general, neither the company nor the contributing owner recognizes any gain or loss when a person acquires an interest in the company in exchange for property, including cash [I.R.C. §721(a)].

The contribution of property may be by an existing owner or a new person. There is no requirement that the transferor of the property be in control of the company to avoid a taxable gain on contribution, as in the case of transfer of property to a corporation.

Basis of Owner

The contributing owner's basis in the company interest ("**outside basis**") is the same as the basis of the property contributed (I.R.C. §722). The basis an owner receives upon a contribution of property is a substituted basis. The determination of an owner's basis may not be as simple as the statute implies, however, since the owner may **increase** basis for his or her share of **liabilities**.

Example 1. Al and Bob decide to form the AB limited liability company. AB does not elect to be a corporation and thus uses its default partnership status for federal income tax purposes. Each member contributes $88,000 in cash to the company. At the time of formation, there are no other assets, no liabilities, and no other members. The basis of each member is $88,000. Immediately, Al and Bob

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decide to admit a new member, Ruth. Ruth contributes some equipment valued at $88,000 to the company. Ruth's basis in the equipment is $60,000 before the contribution. Due to the value of the property, all parties agree that Ruth will be a 1/3 member, and that the company will now be known as ABR, LLC.

As a result of this new arrangement, Ruth will receive an interest in ABR, LLC, valued at $88,000, by arm's-length mutual agreement. She has given up property with an adjusted basis of $60,000. She realizes a gain of $28,000. However, since the limited liability company is a partnership for tax purposes, her contribution of property is nontaxable pursuant to I.R.C. §721(a).

As equal members, all three will have capital accounts of $88,000 for financial accounting purposes. However, Ruth will have a basis of $60,000, the same as the basis in the property she contributed. This is a clear example of **outside** basis.

Effects of Debt on Owner's Basis in Company

When an owner receives an interest in a company, he or she may receive a shift in liabilities. This can have two effects.

1. If an owner **increases** his or her share of company liabilities, the owner is treated as if he or she made a contribution of cash. For basis purposes, this is treated in the same manner as an actual contribution of cash and will **increase** the owner's basis.
2. If the owner contributes property subject to liabilities, his or her personal liabilities may be reduced, since they are now shared among all of the owners. In this situation, the owner is treated as if he or she received a cash distribution simultaneously with the contribution of property.

The key to determining the impact of a liability shift is to determine the owner's share of liabilities. This concept is complicated as the following discussion demonstrates.

In general, the tax law apportions a company's liabilities among the various owners. Thus any alteration in an owner's interest in a company) may cause a reallocation of the company's liabilities.

1. When an owner's share of company liabilities increases, the owner is considered to have made a cash contribution in the amount of increase and adjusts basis in his or her interest upward by the same amount [I.R.C. §752(a), I.R.C. §721(a)].
2. When an owner's share of company liabilities decreases, the owner is considered to have received a cash distribution in the amount of decrease and adjusts basis in his or her interest downward (not below zero) by the same amount [I.R.C. §752(b), I.R.C. §733(1)].
3. There can be hypothetical contributions and distributions whenever any event causes the owners' relative shares of company liabilities to change.
4. Accordingly, it is extremely important to be able to measure every owner's share of the company's liabilities at any point in time.

Each owner's share of company liabilities depends on the following factors:

- Is the liability in question a recourse or nonrecourse liability?
- If it is a nonrecourse liability, what are the precontribution minimum gain, the minimum gain chargeback, and the various owners' shares of profits?
- If it is a recourse liability, what is each owner's relative economic risk, in the worst case scenario?

Recourse Debt

In the partnership taxation rules, a debt is a recourse liability when any owner or any person related to any owner bears the economic risk for payment [Treas. Reg. §1.752-1(a)(1)]. Each owner's share of company **recourse** liabilities is his or her risk of loss [Treas. Reg. §1.752-2(a)].

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2001 Workbook

Historically, in a general partnership setting, this was determined by each general partner's share of the joint and several liability for partnership debts that would be imposed if the partnership lost all of its assets. In a traditional limited partnership setting, the recourse debts were all allocated to general partners.

In a limited liability company, where no member has the responsibility for LLC debts, due to the limited liability company statutes, the members may have no risk of loss for LLC debts. In this case, the debts would be treated as nonrecourse liabilities. However, if a member of a limited liability company guarantees debts of the LLC, there would be a risk of economic loss to the member. Thus the debt would be a recourse liability, within the partnership liability context, and the members would be required to use the recourse liability allocation formula.

- Risk of loss is determined by the owner's obligation on an immediate hypothetical (constructive) liquidation.
- Constructive liquidation is accomplished in the following steps:

1. All properties secured by nonrecourse liabilities are sold for the amount of the liabilities [Treas. Reg. §1.752-2(b)(2)(i)]. Gain or loss on each of these sales is the difference between the amount of liability on each property and the book value of each property [Treas. Reg. §1.752-2(b)(2)(i)].
2. All other properties are sold for zero. The loss on these properties is the book value on the date of constructive liquidation [Treas. Reg. §1.752-2(b)(2)(ii)].
3. At this point, the company has no assets and still has all of its recourse liabilities to pay.
4. At this point, the obligation of each owner to make payments on liabilities must be examined.

Example 2. Refer to Example 1. Immediately after Ruth joins ABR, LLC, the business acquires a new building. It uses $150,000 of its cash and borrows $750,000, for a total cost of $900,000. The building is a company asset, and all members pledge unlimited personal liability for the mortgage.

Assets	
Cash	$ 26,000
Equipment (contributed by Ruth)	88,000
Building	900,000
Total	**$1,014,000**
Liabilities and members' equity	
Mortgage on building	$ 750,000
Capital, Al	88,000
Capital, Bob	88,000
Capital, Ruth	88,000
Total	**$1,014,000**

The basis of the company and each member is as follows.

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Basis of the LLC in its assets

Cash		$ 26,000
Equipment (contributed by Ruth)		60,000
Building		900,000
Total		**$986,000**
Member's outside bases		
Al " Capital"	$ 88,000	
Loan	250,000	
		$338,000
Bob " Capital"	$ 88,000	
Loan	250,000	
		$338,000
Ruth " Capital"	$ 60,000	
Loan	250,000	
		310,000
Total		**$986,000**

Observation. The treatment of liabilities to a partner has no parallel in S corporation tax law. One of the attractive features of the partnership has been the ability of a partner to leverage basis by including a share of the liabilities of the partnership to outside lenders. Contrast this with the debt basis for S corporation shareholders, which can only be obtained by a loan from the shareholder to the corporation. **Thus it may be that the limited liability company provides the protection afforded by the S corporation with the basis treatment of the partnership.** However, as is demonstrated later in the chapter, the at-risk rules may have some unanticipated effects for members of limited liability companies.

Example 3. Refer to Example 2. Immediately after the LLC buys the building, the members' shares of LLC liabilities are determined by calculating a constructive liquidation of the company. First, all of the LLC property, including cash, is treated as if it became completely worthless. (A constructive liquidation is often called the "atom bomb test.") In this example, the total book value of the assets, $1,014,000, would be treated as a loss. Assuming the members are sharing losses equally, as these examples have implied, the loss would be posted to each member's capital account. The effect of the constructive liquidation on each member's capital account would be as follows:

Member	Al	Bob	Ruth
Balance before constructive liquidation	$ 88,000	$ 88,000	$ 88,000
Share of $1,014,000 loss	(338,000)	(338,000)	(338,000)
Balance after constructive liquidation	($250,000)	($250,000)	($250,000)

Each member would have a deficit of $250,000 in his or her capital account after the constructive liquidation. Thus, each member would be obligated to contribute this amount to the company in order to satisfy the creditors. Note that the same result can be obtained by dividing the total debt by the number of members.

In addition, the parties must consider other factors in determining each member's ultimate potential liability:

1. Contractual obligations outside the partnership agreement or operating agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other owners, or to the company [Treas. Reg. §1.752-2(b)(3)(i)].

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2. Obligations to the company that are imposed by the partnership or operating agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the company [Treas. Reg. §1.752-2(b)(3)(ii)].
3. Payment obligations (whether in the form of direct remittances to another owner or a contribution to the company) imposed by state law, including the governing state partnership or LLC statutes [Treas. Reg. §1.752-2(b)(3)(iii)]. Note that this requirement is generally imposed on general partners, but not on members of limited liability companies.

Example 4. Refer to Example 3. Assume that Bob and Al had guaranteed the loan and that Ruth had no personal liability for repayment. The debt would be allocated between Bob and Al.

Nonrecourse Debt

When a company incurs nonrecourse liabilities, there is a different allocation formula. The economic risk criterion is not relevant, since only the lender incurs the economic risk in a nonrecourse arrangement.

Under regulations in effect before 1991, the partners shared this debt in proportion to their profit sharing ratios. Traditionally, with any partnership form other than the limited liability company, nonrecourse liabilities were secured by property. However, the regulations were amended to provide a more complicated allocation formula, that prevented partners from "recycling" nonrecourse debt to new partners.

If the property pledged as security had basis in excess of the debt, the nonrecourse liability was allocated in proportion to each partner's profit sharing percentage. However, if the property's basis is less than the debt for which it is pledged as security an owner's share of nonrecourse liabilities is the sum of:

1. The owner's share of company minimum gain [Treas. Reg. §1.752-3(a)(1)]
2. The amount of gain that would be allocated under I.R.C. §704(c), for contributed property, if the property were sold for the satisfaction of the nonrecourse liabilities and no other consideration [Treas. Reg. §1.752-3(a)(2)]
3. Excess nonrecourse liabilities that do not come under either of the other categories. This portion of the owner's share of nonrecourse liabilities is allocated in accordance with each owner's share of company profits [Treas. Reg. §1.752-3(a)(3)]

Practitioner Note. There are other possible means of allocating the third level of nonrecourse liabilities when there has been a contribution of property to the company subject to nonrecourse liabilities. The regulation specifying allocation of each owner's share of nonrecourse liabilities was modified in 2001. Any practitioner concerned with this problem should read Treas. Reg. §7.752-3 in its entirety.

Example 5. The AB partnership purchases depreciable property for a $1,000 purchase money nonrecourse note. Assume that this is the only nonrecourse liability of the partnership, and that no principal payments are due on the purchase money note for a year. The partnership agreement provides that all items of income, gain, loss, and deduction are allocated equally. Immediately after purchasing the depreciable property, the partners share the nonrecourse liability equally because they have equal interests in partnership profits. A and B are each treated as if they contributed $500 to the partnership to reflect each partner's increase in his or her share of partnership liabilities (from $0 to $500).

The minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain that would be recognized if the partnership disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. Therefore, if the partnership claims a depreciation deduction of $200 for the depreciable property for the year it acquires that property, partnership minimum gain for the year will increase by $200 (the excess of the $1,000 nonrecourse liability over the $800 adjusted tax basis of the property). [See I.R.C. §704(b) and the

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regulations thereunder.] A and B each have a $100 share of partnership minimum gain at the end of that year because the depreciation deduction is treated as a nonrecourse deduction. [See I.R.C. §704(b) and the regulations thereunder.] Accordingly, at the end of that year, A and B are allocated $100 each of the nonrecourse liability to match their shares of partnership minimum gain. The remaining $800 of the nonrecourse liability will be allocated equally between A and B ($400 each) [Treas. Reg. §1.752-3(b), Example 1].

In the limited liability company environment, there may be nonrecourse liabilities that are not secured by LLC property. Under the partnership rules, a nonrecourse liability would be any debt of the company for which no member had any personal liability for repayment, or risk of economic loss. These would include any debts or advances to the LLC for which the lender does not require personal guarantee.

Example 6. Refer to Example 3. Assume that none of the members had personally guaranteed the debt. The debt would be treated as a "partnership nonrecourse" liability. The liability was not contributed to the LLC along with any property. The property pledged as security has a basis that exceeds the amount of nonrecourse liability. Therefore, this debt would be shared among the members in proportion to their profit sharing percentages.

ALLOCATING INCOME AND LOSSES AMONG OWNERS

A company allocates income, losses, deductions, credits, and any other items of tax significance to its owners. As a result of this allocation the owners are required to include their proportionate shares on their personal tax returns, as if they had received or incurred these items directly [I.R.C. §702].

ALLOCATIONS IN GENERAL

The types of items that must be allocated are those that could have an impact on any owner's tax liability. Thus, the company must separately report such items as:

- Long-term capital gain or loss
- Short-term capital gain or loss
- Gain or loss from sale of I.R.C. §1231 property
- I.R.C. §1231 casualty and theft gain or loss
- I.R.C. §179 expensing
- Charitable contributions
- Qualified investment in I.R.C. §38 property
- Disposition of I.R.C. §38 property
- Jobs credit
- Research credit
- Other credits

The company must also identify any of these items by activity, in accordance with I.R.C. §469, and nonactivity items such as portfolio income. It must also report each owner's share of AMT adjustments and tax preferences.

Each of these items is reported for tax purposes as if it occurred on the last day of the company's taxable year [I.R.C. §706(a)].

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DETERMINATION OF EACH OWNER'S SHARE

In general, a company has the flexibility of allocating any or all items of income, loss, deduction, or credit in accordance with the company agreement [I.R.C. §704(a)]. The company agreement may be written or unwritten. The company agreement includes all side agreements among the owners. It includes all amendments to the agreement made prior to the filing of the return [Treas. Reg. §1.704-1(b)(2)(ii)(h)].

However, the IRS may reallocate income among the various owners if an allocation does not meet one of two additional criteria, which are:

- The allocations must be in accordance with each owner's interest in the company
- The allocations must have substantial economic effect [I.R.C. §704(b)]

Owner's Interest in the Company

An owner's interest in the company takes into account the following factors:

- The owners' relative contributions to the company
- The owners' relative interests in economic profits and losses
- The owners' relative interests in cash flows, including current distributions
- The owners' relative rights to distributions in liquidation of the company [Treas. Reg. §1.704-1(b)(3)(ii)].

Observation. When a company makes no effort to allocate any line item of income, deduction, or loss in any manner other than the overall sharing ratios, the allocations of taxable income or loss, including separately reported items, will generally be respected for tax purposes. Thus all line items must generally be reported in equal portions to each owner.

Example 7. Partners A and B each made equal contributions to the AB Partnership. The two partners have agreed that each partner is entitled to equal distributions of partnership income, and are entitled to equal distributions if the partnership liquidates. The partnership must allocate all items of income, loss, and deduction to each of the partners, or the allocation will not be in accordance with their interests in the partnership.

Example 8. A limited liability company has a 60% member, Chris, and a 40% member, Lanny. Chris is entitled to 60% of the company's assets on liquidation of his interest, and Lanny is entitled to 40%.

For the current year, the limited liability company has $70,000 ordinary income, $20,000 long-term capital gains, and $5,000 dividend income. The long-term capital gain arose from a sale of property that had been purchased by the limited liability company. In accordance with their interests, Chris must report 60% of each item, and Lanny must report 40% of each. Any reallocation of any of these items of income would be out of scale with the members' interests in the company.

As the two preceding examples demonstrate, there is little flexibility in making this allocation.

Example 9. Refer to Example 8. Assume that the members would like to keep the same basic 60/40 allocations. However, they would like to amend the agreement so that they will share capital gains in a 50/50 ratio. Unless they can justify a new level of each person's "interest in the partnership (LLC)," they could not sustain the validity of this allocation.

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Substantial Economic Effect Tests

If a company wants to make any special allocations of income or other items to its owners, that differ from the normal profit or loss sharing ratio, the allocations must have substantial economic effect. There are two tests for substantial economic effect, according to the regulations.

1. The allocation must have economic effect–a purely mechanical test.
2. The economic effect must be substantial–a subjective test.

Tests for Economic Effect—General Rules

Allocation of each tax item must be matched by economic burden or benefit [Treas. Reg. §1.704-1(b)(2)(ii)(a)]. In order for the allocation to have **economic effect,** there are three tests that the company must satisfy [Treas. Reg. §1.704-1(b)(2)(ii)(B)].

Practitioner Note. The most important aspect of the substantial economic effect formula is not mentioned directly in the regulations. The basic principal is that the tax accounting rules must follow the financial accounting rules. In other words, book income items must be allocated in the same proportion as taxable income items. There are exceptions for certain required allocations with respect to contributed property.

Example 10. Refer to Example 9. The parties can accomplish this objective, if it has substantial economic effect.

The three tests for economic effect insure that each owner will be allocated his or her proper amount of company assets in the event of liquidation of the owner's interest, or in liquidation of the company. Accordingly, the three keys to understanding economic effect are:

1. The company must maintain capital accounts for each owner in accordance with Treas. Reg. §1.704-1(b)(2)(iv).
2. Upon liquidation of the company, each owner must receive liquidating distributions in accordance with his or her positive capital account balance.
3. Any owner who has a deficit in his or her capital account at the time of liquidation must be obligated to repay the company in the amount of the deficit. However, the obligation to restore a deficit may not be required if the partnership or operating agreement meets the "alternate test for economic effect."

The partnership or operating agreement must be drafted so that the economic effect is permanent, rather than temporary.

Capital Account Maintenance

The capital accounts must be maintained according to the principles contained in Treas. Reg. §1.704-1(b)(2)(iv).

- Capital account maintenance is one of the key concepts for understanding substantial economic effect. Without proper capital accounting, there can be no economic effect, and thus no substantial economic effect. A company that does not maintain capital accounts may only allocate company items in accordance with the owners' interests in the company. No special allocations can be made.
- Accounting for the owner's interest in capital follows financial accounting rules, rather than tax accounting rules.

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- Each owner's capital account must be increased by:

  a. Contributions of money, including any liabilities assumed by the owner from the company [Treas. Reg. §1.704-1(b)(2)(iv)(c)(1)]
  b. Contributions of property, at fair market value less associated liabilities (either assumed by the company or taken by the company with the property)
  c. Allocations of income (including exempt income) and gain to the owner (except for precontribution gain allocations that are not reflected on the books)

- Each owner's capital account must be decreased by:
  a. Distributions of money, which include any assumptions by the company of an owner's liability
  b. Distributions of property, at fair market value less associated liabilities (either assumed by the company or taken by the company with the property)
  c. Allocations of deduction and loss to the owner (except for precontribution loss allocations that are not reflected on the books)
  d. Allocations of nondeductible expenses to the owner

Example 11. Refer to Example 9. The first step to document substantial economic effect is posting each year's activity to each member's capital account. Thus the ordinary income and dividend income will be allocated in the 60/40 ratio, whereas the capital gains will be split 50/50.

For this purpose, assume that Chris's capital account has a balance of $12,000 and Lanny's balance is $8,000 at the start of the current year. Neither member takes a draw or distribution of profits in the current year. The LLC's income items would be posted as follows:

Item	Chris	Lanny	Total
Ordinary income (60/40)	$42,000	$28,000	$70,000
Dividend income (60/40)	$ 3,000	$ 2,000	$5,000
Capital gain	$10,000	$10,000	$20,000
Total to each capital account	$55,000	$40,000	$95,000
Beginning balance	$12,000	$8,000	$20,000
Ending balance	$67,000	$48,000	$115,000

Distributions Based on Positive Capital Account Balances

The partnership or operating agreement must provide that an owner's liquidating distribution must be based on positive capital account balances. Thus those owners who report increased shares of any income items will be entitled to greater proceeds in liquidation than those who report lesser amounts of income.

Example 12. Refer to Example 11. If the allocations had been made in accordance with each member's interest in the company, Chris would be entitled to 60% and Lanny to 40% of the assets in liquidation. However, the changed allocation for the current year leaves Chris with 58.3% ($67,000/$115,000) and Lanny with 41.7% ($48,000/$115,000) of the total company capital. Thus Chris must make an economic sacrifice for reporting a reduced share of the capital gains, since his capital balance is now less than 60% of the total capital.

In short, had the parties retained the original 60/40 sharing arrangement for all items, Chris would still be entitled to 60% of the company's assets upon liquidation. The only way he can report less income is to reduce his stake in the company's assets. If they do not make this type of arrangement, the new allocation cannot have substantial economic effect.

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Effects of Negative Capital Account Balances

The third aspect of the economic effect rule is that there must be some negative consequence to having a negative capital account balance. As a general rule, the owner with the deficit balance must be obligated to restore the balance if he or she ever leaves the company.

Example 13. Phil and Barbara are generally equal members in the PB limited liability company. Each one contributes capital of $10,000. PB loses $18,000 in its first year. If the members allocate in accordance with their interests, each will report $9,000 of the loss. Each will have $1,000 capital account after the first year, and each will still be entitled to 50% of the company's assets in the event of liquidation of the member's interest, or in liquidation of the entire company. Assume, however, that Phil has agreed to give Barbara 80% of the first year loss. The effect would be:

	Phil	Barbara	Total
Ordinary capital contribution	$10,000	$10,000	$20,000
First year loss	(3,600)	(14,440)	(18,000)
Capital end of first year	$ 6,400	($4,440)	$2,000

According to the second criterion of economic effect, Phil should be entitled to $6,400 of the company's assets in the event of liquidation. However, with an initial contribution of $20,000 and losses of $18,000 to date, there are only $2,000 assets remaining. How will Phil get his share of the assets?

The answer is in the third test for economic effect. Barbara must be obligated to contribute $4,400 back to the company at the time of liquidation, since that amount equals her negative capital balance.

Many companies use an alternate for this third aspect. Instead of requiring an owner to unconditionally contribute money back to the company at the time of liquidation, there is a "qualified income offset." This provision requires that an owner whose capital account has unexpectedly become negative due to a loss allocation must be allocated future income of the company until his or her capital account reaches zero. A key factor in this alternative is that it only applies if the negative capital account is due to an unexpected event.

"Substantiality" Test

In order for the economic effect to be substantial, there must be a real risk that the allocation will cause a shift in the various owners' rights, in comparison to what they would have been without the allocation.

Example 14. Refer to Example 8. Assume the original facts, except that Lanny has substantial capital loss carryforwards. Under the interest in company allocation formula, Lanny would only receive $8,000 of capital gain and Chris would receive $12,000.

Therefore, Lanny proposes that he should be allocated all of the capital gain for the current year. If he were to be allocated all $20,000 of the current year's capital gain, he would have a right to $12,000 more of the company's assets than would have been the case if they had not made the special allocation, or the arrangement would not have economic effect.

Accordingly, Chris, who would suffer a detriment in his claim against the company in the event of liquidation, might object to the arrangement.

Accordingly, Lanny proposes that the company allocate $12,000 of additional ordinary income to Chris, so that the members' relative rights would remain intact. The company would post all of the allocations to each member's capital account.

This allocation would have **economic effect**. Unfortunately, this allocation would not have **substantial** economic effect. This is known as a purely transitory allocation. Since the economic effect of one allocation was offset entirely by another allocation it would not be substantial [See Rev. Rul. 99-43, 1999-42 IRB 506].

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Practitioner Note. In practice, the substantial economic effect rules create much more complexity than allocating all items in accordance with each owner's interest in the company. Before owners decide to make special, or disproportionate allocations of any company item, they should be prepared to comply with all of the record keeping that the substantial economic effect alternative requires.

LIQUIDATION OF AN OWNER'S INTEREST

A company may liquidate an owner's interest. The interest may be that of the actual owner, of the successor in interest of a deceased owner, who has an economic interest in the company.

There are alternatives to liquidation of owner's interests. For instance, an owner may sell his or her interest to a new owner, to an existing owner, or some combination thereof. An owner may give his or her interest to a family member, charitable organization, or other person or entity. The sale, gift or other disposition of an owner's interest has some different consequences from "liquidation" of an owner's interest, and is not discussed in depth in this book.

DISTRIBUTIONS TO RETIRING OWNER OR DECEASED OWNER'S SUCCESSOR

In general, I.R.C. §736 covers distributions by a company to a retiring owner or a deceased owner's successor in interest. There are two basic rules under this provision:

1. Payments to an owner in exchange for his or her share of company property are treated as **distributions** in exchange for property. Thus the recipient and the company are subject to the distribution rules for this portion of the liquidation.
2. Any payments **beyond an owner's interest** in company property are treated as **ordinary income** to the owner. The treatment at the company level depends on whether the payments are based on company profits after the retirement or death, or are based on a fixed formula. In general, the other owners are allowed a deduction for this portion of the payment.

In order to separate these two components, I.R.C. §736 requires that the company must determine the fair market value of the retiree or successor's interest in company property. If the payments will not exceed this fair market value then there are no ordinary income/ordinary deduction payments. Instead all of the payments will be treated as distributions to an owner.

- The rules of I.R.C. §736 apply only to payments from a company to a retiree or successor [Treas. Reg. §1.736-1(a)(1)(i)].
- They do not apply to any dealings between owners or former owners.

Definition of Retired Owner

An owner is retired when he or she is no longer an owner under local law [Treas. Reg. §1.736-1(a)(1)(ii)]. Under I.R.C. §736, however, that person is considered to be an owner, rather than an outsider, until his or her interest in the company has been completely liquidated. In essence, a retiring owner is somewhere between an owner and a nonowner.

Example 15 . Jerry ceases to be a partner, under local law, in the JKP Partnership on April 22, 1993. The partnership will buy out his interest in several installments, which will end on April 22, 1997. Up to April 22, 1993, Jerry is a partner for all purposes. After April 22, 1997, Jerry is not a partner in any sense of the word. Between the two dates he is a retiring partner.

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Deceased Owner's Successor in Interest

A deceased owner's successor in interest is one who has rights to the deceased owner's company profits or capital, but is not an owner under local law [Treas. Reg. §1.736-1(a)(1)(i)].

Perhaps the most frequent example of this situation occurs when there is a licensed professional partnership or LLC, such as a medical, legal or CPA practice, and the state governing body requires that every owner hold a license to practice the profession. If the owner dies, the estate, surviving spouse, or other successor now holds an economic interest in a company in which the successor may be legally barred from becoming an owner by state law. However, this person still has an economic interest in the company and will be treated as a "partner" for federal income tax purposes.

Treatment of "Distributions" in General

The first concern in liquidation of an owner's interest is to determine the payment in exchange for his or her share of the "partnership property." This term has a special meaning in the context of liquidating distributions. It varies accordingly for professional service general partnerships and for other partnerships or limited liability companies (see later discussion, under Application of I.R.C. §736 to General Owner in Service Company and Application of I.R.C. §736 to Limited Owner or Owner in Capital Intensive Company). Up to this value, the payments are subject to the same distribution rules as would be the case in a nonliquidating distribution to an owner.

Nonrecognition of Gain or Loss

In general, an owner recognizes no gain or loss when the company distributes money or other property [I.R.C. §731(a)(1)]. This rule will apply to a liquidating distribution up to the value of the owner's property interest. However, as the following discussion indicates, there are several important exceptions to this rule.

Cash in Excess of Basis

When an owner receives cash in excess of his or her basis in the company he or she must recognize gain to the extent that cash exceeds basis. The owner's basis includes all income or loss items up to the date of the distribution. If there is a series of liquidating distributions, the owner's basis would be determined at the time he or she ceased to be an owner, and is now a "retired owner," as was discussed earlier under Definition Of Retired Owner.

Effect of Reduction in Liabilities

According to I.R.C. §752(b), a reduction of an owner's share of liabilities is treated as a distribution of cash. Thus any reduction in an owner's share of company debts must be determined when there is a liquidation of his or her interest. If the release is immediate and all other owners agree to take over the departing owner's share of debts, there would be an immediate "cash" distribution of the owner's entire portion of liabilities. However, if the departing owner retains all or a portion of his or her obligation to the company's creditors, there will be no deemed distribution until the owner is released.

> **Practitioner Note.** The release of liability of a retiring owner must be determined on a case-by-case basis. The tax advisor must consult the partnership or operating agreement, the agreement governing the liquidation, specific agreements with creditors, other owners' indemnifications, and local law to determine the actual dates and amounts of the liability relief.

Requirements for Loss Recognition

Under no circumstances may an owner recognize a loss on a current distribution. However, in a liquidation distribution an owner may recognize a loss, but only if:

- The owner retains no interest in the company after the distribution

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- The owner receives no property other than cash, unrealized receivables, inventory items, or any combination thereof
- The amount of cash, plus the company's basis in inventory items distributed, is less than the owner's basis in his or her interest immediately prior to the liquidating distribution [I.R.C. §731(a)(2)]

Character of Gain, in General

A partnership interest, or interest in a limited liability company is generally treated as a capital asset to the owner. Therefore, any gain or loss on the sale or distribution is treated as a capital gain or loss (I.R.C. §741).

Ordinary Income for Reduction In "I.R.C. §751 Property"

When a distribution, including a liquidating distribution, results in a reduction of an owner's share of the company's "unrealized receivables" or "inventory items (but only if substantially appreciated)," the owner is treated as if he or she sold the company his or her proportionate share of these assets [I.R.C. §751(b)]. This phenomenon, often termed a "disproportionate distribution," occurs whenever the company retains its ordinary income property and distributes cash or capital assets to the owner.

There are some rather strange definitions of "unrealized receivables," which include cash method account receivable, but also depreciation recapture under I.R.C. §1254, and various other ordinary income provisions [I.R.C. §751(c)]. The statute also stretches the definition of "inventory items" to include most any asset that would result in ordinary income if sold by the company.

Practitioner Note. The rules regarding disproportionate distributions are unduly complicated, and require numerous calculations and assumptions in all but the simplest of situations. These rules have been covered in earlier editions of the *Farm Income Tax School Workbook*.

Disguised Sale

If a distribution, including a liquidating distribution, occurs within two years of the contribution of non-cash property by the retiring owner, it may be reclassified as a disguised sale. Under this rule, the earlier contribution is recast as a deferred payment sale. [See I.R.C. §707(a), and Treas. Reg. §1.707-3 for additional details].

Distribution with Respect to Recent Contribution

When an owner has contributed noncash property and receives a distribution of noncash within seven years, the company may be required to recognize gain, but only if the fair market value of the noncash property received exceeds the owner's basis [I.R.C. §737]. This phenomenon is unlikely, but possible, when a company liquidates an owner's interest by distributing property other than cash.

Distribution of Recently Contributed Property

When an owner of a company receives noncash property as part or all of the distribution in liquidation of his or her interest, there are several additional rules that apply. One of these governs a distribution of any property that was contributed to the company by another owner within the past seven years [I.R.C. §704(c)(1)(B)]. In this case, the company may be required to recognize a certain amount of gain or loss, which will be allocated back to the owner who made the contribution.

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Other Problems with Receiving Noncash Property

The receipt of noncash property in a liquidating distribution has several ramifications. Among these are

- Neither the company nor the owner recognizes any gain (except for the exceptions above for unrealized receivable and inventory items, disguised sale and recent contributions).
- The owner takes a carryover basis from the company in the property received. Thus the company's predistribution basis becomes the owner's basis after the distribution [I.R.C. §732(a)(1)].
- The basis of the property received cannot exceed the owner's basis prior to the distribution (after factoring in any adjustments to basis as a result of the disguised sales, or other gain recognition rules discussed above) [I.R.C. §732(a)(2].
- If the owner's basis exceeds the company's predistribution basis of a capital asset or I.R.C. §1231 asset, the distributed property takes a basis equal to the owner's basis in his or her interest, after reduction for any cash, receivables or inventory items distributed [I.R.C. §732(b)]. The basis allocation formula can become complicated when there is a distribution of multiple noncash assets (see I.R.C. §732(c) and the *1997 Farm Income Tax School Workbook*).

Identification of Owner's Interest in Company Property

I.R.C. §736(b) treats all payments to the retiree or successor as payment in exchange for **company property**. If a payment is made to an owner in exchange for his or her interest in company property, there are two ramifications:

1. The owner receiving the payment recovers his or her basis and reports any additional payment as gain. The gain may be characterized by I.R.C. §751(b) as ordinary income, to the extent that the owner's share of hot assets changes. There are, however, special rules for the definition of hot assets that are applicable only in the context of I.R.C. §736.
2. The company that makes the payments does not deduct the payments. If the payments made by the company are unequal to the owner's basis in company property, the company may adjust its basis in assets retained, but only if the company has an I.R.C. §754 election in effect for the year.

Depending on the type of company (general, limited, etc.) and the class of owner (general or limited) there are divergent definitions of **company property**.

1. If capital (as opposed to services) is not a material income producing factor of the company, and the retiree is a general owner (or the deceased owner was a general owner), **company property does not include unrealized receivables** (defined by rules only applicable to I.R.C. §736). In this situation, company property does not include the retiree's share of company goodwill, unless the partnership or operating agreement specifically treats goodwill as company property.
2. If the retiree is not a general owner, or if **capital is a material income** producing factor, payments in exchange for the retiree's interest in **company property include unrealized receivables and goodwill** (regardless of the treatment of goodwill specified in the partnership or operating agreement). Thus it is difficult for this type of company to ever be entitled to an ordinary deduction for a payment in liquidation of an owner's interest.

Practitioner Note. The Internal Revenue Code does not define the term "general partner." By inference, the term probably excludes any person who is a limited partner, according to a state's limited partnership act. A member of a limited liability company would probably be classified as a general partner or as a limited partner based on his or her rights to participation in management. However, there is some uncertainty in this area.

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Special Rules for Unrealized Receivables

As of 1993, the definition of **unrealized receivables** was modified for the application of I.R.C. §736.

- According to the current wording of I.R.C. §751(c), when used in context of a distribution governed by I.R.C. §736, unrealized receivables include rights to payment for goods or services that have not been included in company income, due to the company's method of accounting.
- For purposes of I.R.C. §736, however, unrealized receivables do not include depreciation recapture, and other ordinary income items such as mining property, franchises, and other special items.

Gain or Loss to the Retiring Owner

The gain recognized on a liquidating distribution is of the same character as that on a nonliquidating distribution. Thus the retiree, and the company, must be aware of the potential for ordinary income attributable to the retiring owner's relinquishment of a share of any unrealized receivables or inventory items. The remainder of any gain is capital gain. Any loss on the liquidating distribution is also capital loss.

APPLICATION OF I.R.C. §736 TO GENERAL OWNER IN SERVICE COMPANY

Company property does not include any unrealized receivables, except for depreciation recapture.

- In general, company property does not include the retiring owner's share of goodwill.
- Any payment to an owner in exchange for his or her unrealized receivables are treated as I.R.C. §736(a) payments.
  - **a.** The partnership or operating agreement may specify that goodwill is company property. Under such an agreement, payments to the retiree for his or her share of goodwill are treated as payments in exchange for property.
  - **b.** Company property does include all other assets, including substantially appreciated inventory items.

Example 16. Gerri is retiring from the Falcon Partnership. Prior to her retirement, Gerri was a general partner, who owned 10% of the partnership's capital, profits and losses. Capital is not a material income-producing factor to Falcon, which provides consulting services. The balance sheet immediately before her retirement is:

	Adjusted Basis	Fair Market Value
Assets		
Cash	$ 21,000	$ 21,000
Accounts receivable	0	120,000
Furnishings and equipment	15,000	24,000
Land and building	64,000	95,000
	$ 100,000	$ 260,000*
Liabilities and capital		
Accounts payable	0	$ 40,000
Capital (Gerri)	$ 10,000	22,000
Capital (other partners)	90,000	198,000
	$100,000	$260,000

*There is no recapture of depreciation under either I.R.C. §1250 or I.R.C. §1245 on the building. However, there is I.R.C. §1245 depreciation recapture on the furnishings and equipment. If the partnership were to sell these assets at fair market value, the recapture would be $9,000.

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Gerri's share of partnership property excludes her portion of the unrealized accounts receivable. Therefore her share of partnership property is.

Total value of partnership assets	$260,000
Less partnership unrealized receivables	(120,000)
Total value of partnership property	$140,000
Gerri's share (10%)	$ 14,000

The first $14,000 of payments Gerri receives from the partnership will be treated as payments received for her interest in partnership property. She will treat that portion of the payment in the same manner as any other distribution. Since Gerri's inside basis is $10,000, she would report no gain on the first $10,000 she receives [I.R.C. §751(b)].

After the payments exceed $10,000 Gerri will report gain. Of this gain, $900 would be ordinary income since that is her portion of the partnership's depreciation recapture. The remaining gain (up to $3,100) would be capital gain.

The continuing partnership would not deduct any of the first $14,000 of payments to Gerri. The partnership would adjust its basis in the assets it retained, but only under one of two conditions:

1. Any portion of the distribution that was treated as a taxable transaction under I.R.C. §751(b) would result in a cost basis for the assets deemed purchased by the partnership in this portion of the transaction.
2. The partnership could adjust basis for any gain or loss recognized by Gerri, but only if it had an I.R.C. §754 election in effect for the year.

Any payments in excess of $14,000 would be ordinary income to Gerri as a guaranteed payment and deductible (directly or indirectly) to the continuing partnership.

APPLICATION OF I.R.C. §736 TO LIMITED OWNER OR OWNER IN CAPITAL INTENSIVE COMPANY

If an owner died or retired before January 5, 1993, the rules governing I.R.C. §736(b) and I.R.C. §736(a) payments were the same as those discussed above. On or after January 5, 1993, there are two conditions that the company and the owner must meet, or the payments for unrealized receivables will be treated as payments in exchange for company property.

1. Capital (as opposed to services) must not be a material income producing factor to the company.
2. The owner must have been a general owner [I.R.C. §736(b)(3), added by Revenue Reconciliation Act of 1993, I.R.C. §13262(a)].

Any payment for a limited owner's share of unrealized receivables or goodwill will be treated as a payment in exchange for company property. The same treatment would govern a payment to a retiring owner of a company. Any payment in exchange for a general owner's share of unrealized receivables or goodwill will be treated as a payment in exchange for company property, if capital is a material income producing factor of the company.

- The Committee reports to the Revenue Reconciliation Act of 1993 do not define the term "material income producing factor." They refer to I.R.C. §401(c)(2), which governs contributions to Keogh plans, and I.R.C. §911, which allows an exclusion for earned income from foreign sources, by foreign residents.

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- The Committee reports to the Revenue Reconciliation Act of 1993 specifically state that capital is not a material income producing factor in companies that are engaged primarily in providing personal services.

The Internal Revenue Code does not define the term "general partner." By inference, the term probably excludes any person who is a limited partner, according to a state's limited partnership act.

A member of a limited liability company would probably be classified as a general partner or as a limited partner based on his or her rights to participation in management.

AGREEMENT PATTERNS FOR THE RETIREMENT OF AN OWNER

- The total amount of payment is fixed.
- Payments for company property are fixed, plus an additional payment to be made to the owner that will vary with income, sales, or some other factor in the future.
- The total payment is subject to some future variable, such as sales or income.

Each one of these patterns has a different treatment to both the retiree and the continuing company. The partnership regulations are specific on how the retiree reports the gain from the distributions in exchange for company property. When the payments occur over more than one year, the retiree first recovers basis.

However, the regulations under I.R.C. §751(b) treat the owner's reduction of a proportionate share of I.R.C. §751 property as if the owner had received the property in a nonliquidating distribution and then sold it back to the company.

The I.R.C. §736(a) payments, for unstated goodwill and for cash method accounts receivable, are ordinary income. With this information, it is now possible to complete the example from the retiree's perspective.

Example 16 (continued). Assume that Gerri is to receive $7,000 per year over the next three years, rather than one payment of $14,000. These must be allocated to payments for property as follows:

Payments for property	$ 14,000
Total payments	$ 21,000
Percent of all payments to be treated as property payments	.6667

Note that the cash method receivables are not treated as "property" for this purpose. The cash method payables, of which Gerri is relieved, are not treated as payments, even though the reduction of her share of these debts would normally be considered as an additional payment under I.R.C. §752(b).

The year by year breakdown is as follows:

	Payment for		
Year	**Property**	**Other**	**Total**
1	$ 4,667	$2,333	$ 7,000
2	4,667	2,333	7,000
3	4,667	2,333	7,000
Total	$14,000	$7,000	$21,000

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Gerri must determine the basis and gain to be reported from the $14,000 payments for her interest in partnership property.

Total property payments	$14,000
Her share of partnership basis (10% of $100,000)	(10,000)
Gain	$4,000

Of this gain, there are two components.

The reduction in Gerri's share of the partnership's depreciation recapture is treated as a fully taxable sale of this asset by Gerri under I.R.C. §751(b). Thus, conceptually, her first gain is ordinary income. The remaining gain is capital gain under I.R.C. §742.

Ordinary income (10% of partnership depreciation recapture)	$ 900
Capital gain	3,100
Total	$4,000

The partnership regulations are specific on how the retiree reports the gain from the distributions in exchange for company property. When the payments occur over more than one year, the retiree first recovers basis.

However, the regulations under I.R.C. §751(b) treat the owner's reduction of proportionate share of I.R.C. §751 property as if the owner had received the property in a nonliquidating distribution and then sold it back to the company.

The I.R.C. §736(a) payments, for unstated goodwill and for cash method accounts receivable are ordinary income. With this information, it is now possible to complete the example from the retiree's perspective.

Example 16 (continued). Gerri treats her payments as follows:

Year	Return of Basis	Capital Gain	Ordinary Income
1	$ 4,667		$ 3,233*
2	$ 4,667		$ 2,333
3	$ 667	$ 3,100	$ 2,333
Total	$ 10,000	$ 7,000	$ 7,900

*$900 of depreciation recapture plus $2,333 of unstated goodwill.

Falcon would need to report this information to Gerri on her Schedule K-1 each year. Since the payments for unstated goodwill and accounts receivable are fixed in nature, they are treated as guaranteed payments of $2,333 each year. The remaining amounts are treated as cash distributions and disclosed appropriately on Schedule K-1.

The company parallels the timing of the retiree's reporting. There are some additional complications. First, the ordinary income payments for accounts receivable and unstated goodwill are deductible as guaranteed payments when paid. The distributions in exchange for the owner's share of company property are not deductible. These payments cause no basis adjustment or any other tax effect until the retiree begins to report gain. At that time, the company may begin to adjust basis of its assets. Any depreciation recapture reported by the retiree allows the company to step up the basis of the depreciable asset in which the retiree has relinquished an interest. This step up is treated as newly purchased depreciable property. The company need not have an I.R.C. §754 election in effect for this basis adjustment to occur. When the owner reports capital gain from the distribution, the company may adjust basis of its other assets, but only if the company has an election under I.R.C. §754 in effect. See discussion below.

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Example 16 (continued). Falcon treats its payments to Gerri payments as follows:

Year	No effect on Basis	Basis adjustment	Ordinary Deduction
1	$ 3,767	$ 900*	$2,333
2	4,667		2,333
3	1,567	3,100**	2,333
Total	$10,000	$4,000	$7,000

- $900 adjustment to depreciable assets, regardless of any I.R.C. §754 election for year 1
- $3,100 would be allowed as a basis adjustment to the land and building if the partnership had an I.R.C. §754 election in effect for year 3

I.R.C. §743 BASIS ADJUSTMENT AFTER THE TRANSFER OF A COMPANY INTEREST

Certain basis adjustments may be necessary to bring a company's aggregate inside basis into conformity with the owners' collective outside bases. The imbalance may occur when:

- A new owner acquires his or her interest by purchase.
- There is a new owner or a deceased owner's successor in interest by reason of death of the former owner.
- A distribution from the company to an owner results in a gain or loss under I.R.C. §731.
- A noncash distribution from the company to an owner results in a changed basis of the distributed property under I.R.C. §731.

ELECTION TO ADJUST BASIS OF COMPANY PROPERTY AFTER SALE, DEATH, OR DISTRIBUTION

Before any adjustment to basis of company assets may be achieved, the company must make an election under I.R.C. §754.

- The company files an election under I.R.C. §754 to enable it to make basis adjustments to its own property after certain transfers and distributions.
- The election, once made, is binding on all future years.
- An election under I.R.C. §754 may be revoked only with consent of the IRS.
- The specific rules for basis adjustments are contained in I.R.C. §755.

Purpose of I.R.C. § 754 Election

In certain cases, the transfer of interest in a company may result in an imbalance between the new owner's outside basis, and the new owner's portion of the inside basis of the company's assets. An owner who purchases an interest from another owner takes a cost basis in his or her interest [I.R.C. §742, §1012]. An owner who receives an interest due to the death of an owner takes a basis of fair market value date of death (or alternate valuation date) of the deceased owner.

Without an election under I.R.C. §754, there is no basis adjustment to company assets [I.R.C. §743(a)].

- The retained basis of company assets after a sale or exchange can work an injustice on the purchasing owner.

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Example 16. X sells 1/3 interest in XYZ partnership. XYZ conducts a service operation on the cash basis. X's basis in the partnership interest is $46,000, after adjustment for all items of income, loss and distributions to the date of the sale. The partnership's balance sheet immediately before the sale shows the following.

Assets	Basis	FMV
Cash	$ 30,000	$ 30,000
Receivables	0	60,000
Equipment	63,000	72,000
Land	45,000	87,000
	$138,000	$249,000
Liabilities	0	$ 15,000
Capital X	$ 46,000	78,000
Capital Y	46,000	78,000
Capital Z	46,000	78,000
	$138,000	$249,000

X receives $78,000 cash from A, the buyer. A also assumes X's share of liabilities, or $5,000. Therefore, A's basis becomes $83,000, which is exactly 1/3 of the fair market value of partnership assets. X will report a gain on the sale, which will be allocated between ordinary income and capital gain. In essence, A has purchased 1/3 of the assets at their fair market value.

Assume that the partnership does not have an I.R.C. §754 election in effect. If the partnership immediately sold all of its assets at their fair market value, the partnership would report $111,000 of gains and income. A's share would be $37,000. Thus the gain, which was already reported by X on the sale of the partnership interest to A, is again reported by A when the partnership sells its assets. An I.R.C. §754 election would allow the partnership to adjust the basis of its assets, following the admission of A. Therefore, the gain would not be taxed twice.

Procedures for Election

The company must file an election with the partnership Form 1065 for the first year in which it is to take effect [Treas. Reg. § 1.754-1(b)(1)].

- The Form 1065 must be timely filed, including extensions.
- There is no prescribed form, but a written statement must be included with the return.
- Election is binding on all future years. It may only be revoked with permission of the IRS. The IRS lists the conditions under which it will normally grant a revocation in Treas. Reg. §1.754-1(c). The company must demonstrate that retention of the Treas. Reg. §754 election will result in an increased administrative burden due to one of the following:
  - **a.** A change in the nature of the company business
  - **b.** A substantial increase in the assets of the company
  - **c.** A change in the character of assets, or an increased frequency of retirements or shifts of company interests
- The IRS will not grant a revocation if the primary purpose of the revocation is to avoid stepping down the basis of assets.

ADJUSTMENT FOLLOWING SALE OR EXCHANGE OR TRANSFER AT DEATH

I.R.C. §754 provides no mechanism for actually achieving its results. However, I.R.C. §743(b) governs the basis adjustment following a sale of company interest or death of an owner. The adjustments required by I.R.C. §743(b) are dichotomous.

- The basis adjustments are made by the company, rather than by the individual owner.
- The adjustments can only benefit the owner who has acquired the company interest.

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The I.R.C. §743(b) adjustments focus on the change in outside basis from the former owner to the new owner.

- If the new owner's basis exceeds that of the former owner, the company adjusts the basis of its assets upwards, so that the new owner's share of inside basis is the same as his or her outside basis.
- Conversely, if the new owner's outside basis is less than the outside basis of the former owner, the company must reduce the basis of its assets, so that inside and outside basis to the new owner are equalized.
- If the company has a mix of assets that have appreciated and depreciated at the time of a transfer, the rules for allocation need further explanation.
- When all of the assets have depreciated, or all of the assets have appreciated, however, the company merely adjusts each asset's basis.

Example 17. Refer to Example 16. After the admission of A as a partner, the partnership's balance sheet, at tax basis, would appear as follows, without an I.R.C. §754 election in effect.

Assets	Basis	FMV
Cash	$ 30,000	$ 30,000
Receivables	0	60,000
Equipment	63,000	72,000
Land	45,000	87,000
	$138,000	$249,000
Liabilities	0	$ 15,000
Capital A	$ 78,000	78,000
Capital Y	46,000	78,000
Capital Z	46,000	78,000
Unallocated basis	(32,000)	
	$138,000	$249,000

The unallocated basis account is not an asset or liability. Its sole purpose is to keep the books in balance. Actually if the partnership were using the prescribed methods for computing partners' capital accounts, A's capital would be the same as X's capital account balance. With an I.R.C. §754 election in effect, however, the partnership will adjust the basis of each appreciated asset to bring the basis in line with the partner's capital. The aggregate adjustment is $32,000. In this example, the partnership would increase the basis by 1/3 of the difference between the old basis, and the fair market value of each asset, since A has purchased a 1/3 interest in each asset. The balance sheet, at tax basis, after the I.R.C. §754 election, follows:

Assets	Basis	FMV
Cash	$ 30,000	$ 30,000
Receivables	0	60,000
I.R.C. §754(b) adjustment	20,000	
Equipment	63,000	72,000
I.R.C. §754(b) adjustment	3,000	
Land	45,000	87,000
I.R.C. §754(b) adjustment	14,000	
	$175,000	$249,000
Liabilities	0	15,000
Capital A	78,000	78,000
Capital Y	46,000	78,000
Capital Z	46,000	78,000
	$175,000	$ 249,000

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The basis adjustments posted to the receivables, equipment and land would only be for the benefit of partner A. For example, when the partnership collects the receivables, it will post ordinary income of $60,000, in total, to the partners' capital accounts, and report the same on each partner's Schedule K-1, Form 1065. Thus partner A will be allocated $20,000 ordinary income from the receivables, along with each of the other partners. A, however, will also be allocated and ordinary deduction of $20,000 resulting from the I.R.C. §743(b) adjustment, which will offset his income from these receivables in full.

The partnership would also allocate the $3,000 adjustment to the equipment entirely to A. Thus, if the partnership sold the equipment immediately, A would be able to offset his share of the gain (or increase his share of the loss) from the sale with the $3,000 basis adjustment. If the partnership did not sell the equipment, it would depreciate the $3,000 basis adjustment as if it were depreciable property placed in service on the date of A's purchase from X. The depreciation on this asset would be allocated entirely to A.

- The partners' capital accounts are not adjusted to reflect adjustments to basis under I.R.C. §743(b) [Treas. Reg. §1.704-1(b)(2)(iv)(m)(2)].

DETERMINATION OF TRANSFEREE'S ADJUSTMENT

Treas. Reg. § 1.743-1 explains the manner in which the transferee owner (e.g., buyer or heir) determines the amount of the I.R.C. § 743(b) adjustment.

The adjustment is generally computed as follows:

Owner's outside basis (determined normally, includes share of liabilities)
– Owner's inside basis
I.R.C. §743(b) adjustment

Owner's Inside Basis

For this purpose, the owner's inside basis is its share of previously taxed capital plus the owner's share of company liabilities. Previously taxed capital is the amount of cash that the new owner would receive on a liquidation of the company following the **hypothetical transaction** (e.g., a sale) increased (decreased) by the amount of tax loss (gain) (including any remedial allocations under I.R.C. §1.704-3(d)) that would be allocated to the transferee from the hypothetical transaction. The formula for computing the owner's inside basis and previously taxed capital is shown below:

Owner's share of liabilities
+ Interest in **previously taxed capital**
  Cash received on liquidation after hypothetical transaction
  – Gain recognized to owner on hypothetical sale
  + Loss recognized to owner on hypothetical sale
Owner's inside basis

The hypothetical transaction is a sale of all the company assets for FMV in a fully taxable transaction immediately after the transfer (e.g., purchase or death). Gain and loss allocated to the transferee owner for this purpose includes any gain that the transferee owner "inherits" or "buys" with the interest under I.R.C. § 704(c).

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Example 19. A, B, and C form partnership PRS contributing the following assets each receiving a 1/3 interest:

Partner	Contributed Property	FMV	Partnership's Adjusted Basis
A	Land	$1,000	$400
B	Cash	1,000	1,000
C	Cash	1,000	1,000
	Total	$3,000	$2,400

During the partnership's first taxable year, the land appreciates by $300 to $1,300 and partner A sells her one-third interest to transferee T for $1,100 (1/3 × $3,300). The partnership properly made an election under I.R.C. §754. Note that partner A recognizes a gain of $700 ($1,100 – $400), which economically represents the built-in-gain at the time of the contribution of $600 and her $100 (1/3 × $300) share of the appreciation since the contribution. T would determine his I.R.C. § 743(b) adjustment as follows:

T's outside basis		$1,100
T's inside basis		
Interest in previously taxed capital		
Cash distributed upon liquidation after deemed sale (1/3 × $3,300)	$1,100	
– Gain on deemed sale of assets ($1,300 – $400)	$900	
Precontribution gain to partner	($600)	
Share of remaining gain (1/3 × $300)	($100)	
Interest in previously taxed capital	$400	($400)
Section 743(b) adjustment		$700

Adapted from Prop. Reg. § 1.743-1(b)(3) Example 2

ADJUSTMENT FOLLOWING A DISTRIBUTION OF PROPERTY TO AN OWNER

I.R.C. § 734(b) governs the basis adjustment after certain distributions when a company has an I.R.C. §754 election in effect.

- The basis adjustments under I.R.C. §734(b) reflect gain or loss, or change in basis resulting from a distribution.
- Unlike the adjustments under I.R.C. §743(b), these adjustments are applied to the common basis of the assets, and all owners benefit (or pay in the form of reduced basis).

Example 20. Refer to Example 18. Assume the same facts, except that the existing partnership had liquidated X's interest for $83,000 cash, including liability relief. The adjustments to the basis of each asset would be the same as those shown in Example 18. The allocation of the tax benefit would be to all of the continuing partners.

- The partners capital accounts are adjusted to reflect adjustments to basis under I.R.C. §734(b) [Treas. Reg. §1.704-1(b)(2)(iv)(m)(4)].
- This adjustment is limited to the new book value [Treas. Reg. §1.704-1(b)(2)(iv)(m)(5)].
- The adjustment is limited to capital and I.R.C. §1231 assets. Any ordinary income assets would have already been adjusted under the deemed sale rules of I.R.C. §751(b).

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ALLOCATION OF BASIS ADJUSTMENTS TO SPECIFIC ASSETS

I.R.C. §755 prescribes allocation to specific assets.

Allocation Where Company Does Not Constitute a Going Business

In order to comply with the rules of I.R.C. §755, for any adjustment under either I.R.C. §743(b) or I.R.C. §734(b), the company must follow a three step process:

1. Divide assets into two classes:
   - All capital and Section 1231 assets
   - All other assets
2. Allocate adjustment to each class, based on the contribution of the class to the entire appreciation or depreciation of the company's assets.
3. Allocate to specific assets within each class, based on the contribution of each asset to the total appreciation or depreciation of the class. If the basis adjustment is positive (negative), it must be allocated only to appreciated (depreciated) assets based on relative appreciation (depreciation) in each class.

Example 21. The ABC Partnership has the following balance sheet:

	Adjusted basis	FMV
Capital assets	$1,000	$1,500
I.R.C. §1231 assests	1,000	700
Other assets	700	800
	$2,700	$3,000

A sells his entire 1/3 interest to D for $1,000.
The total adjustment under I.R.C. §743(b) is $100.

Divide into two classes: (1) Capital and I.R.C. §1231 and (2) all other.

	Adjusted basis	FMV
Capital asset	$1,000	$1,500
I.R.C. §1231	1,000	700
	$2,000	$2,200
Appreciation		$200

Other assets

	Adjusted basis	FMV
	$ 700	$ 800
Appreciation		$ 100

1. The capital and I.R.C. §1231 assets have 2/3 of the total appreciation. Therefore they receive $67 of the $100 adjustment. Since the capital asset is the only property within the class that has appreciated, it receives the entire $67 adjustment allocated to the class.
2. The ordinary asset receives the $33 (1/3 × $100) adjustment.
3. Since the transaction that gave rise to the adjustment was a purchase of a partnership interest, the adjustment may only benefit the purchasing partner.
4. If the partnership had liquidated A's interest in a distribution, the adjustments would benefit all of the continuing partners.

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Allocation Where Company Does Constitute a Going Business

I.R.C. §1060 applies to these transactions, and mandates the use of the residual method.

- When an owner buys an interest in the company, or the company liquidates an owner's interest, and the company has an I.R.C. §754 election in effect, the partnership regulations require that the company use the same method in determining the allocation to each individual asset of the company [Treas. Reg. §1.755-2T].
- The regulations under I.R.C. §1060 require the taxpayer to use the residual method to allocate the consideration among the assets. Under the regulations, all of the assets are first assigned to one of seven categories as follows. [see Treas. Reg. §1.1060-1T(d); see discussion in the *2000 Farm Income Tax School Workbook*].

GIFT OF MORE THAN 50% COMPANY INTEREST

An owner may dispose of his or her company interest by means other than a sale or liquidating distribution. Transfer to another company, transfer to a corporation, transfer at death and transfer by gift are possible means of disposing of an interest in a company.

GIFT AND PARTIAL SALE PROBLEMS

Disposition by gift may be treated as a partial sale of the interest, to the extent that the donor is relieved of a portion of company liabilities. In *Robinson v. United States*, 61 AFTR 2d 88-395, 88-1 USTC ¶9120 (DC PA 1987), a partner gave portions of his interest in a partnership to his children. The District Court held that the transfer was a sale, rather than a gift, to the extent that Mr. Robinson's share of partnership liabilities was reduced. The Court's opinion was by no means a novel construction of the statute. Indeed, I.R.C. §752(b) treats company liabilities in the same manner as liabilities associated with other property, when an owner sells or exchanges his or her company interest.

A true gift of an entire interest in a company can occur when the company is completely free of debt, which is an unlikely situation. A gift may, however, occur in two other situations:

- An owner may be able to dispose of a portion of his or her interest in a company by gift, when there are no recourse liabilities in the company, the donor has personally guaranteed some of the company debt, and the donor is not relieved of any of his or her personal guarantee.
- An owner may transfer a company interest to his or her spouse (or former spouse if the transfer is pursuant to the divorce). In such a case, the transferee takes on the transferor's basis, even though liabilities exceed basis (I.R.C. §1041 and the regulations thereunder).

Example 22. Owen owned an interest in a partnership. His basis was only $2,000, but his share of liabilities was $20,000. In most transactions, Owen could not give the partnership interest to another person without the transfer being characterized as a sale, at least to the extent of the $20,000 liabilities. He transfers the partnership interest to his wife, Martha. Owen recognizes no gain on the transfer, and Martha receives a basis of $2,000 in the partnership interest.

TERMINATION OF THE COMPANY

When an owner sells his or her interest in a company, the company is continued for tax purposes, unless one of three events happens:

1. There is now only one owner.
2. The entity no longer conducts any business activity.
3. Within the 12-month period ending on the date of the sale, 50% or more of the company's capital and profits interests have been sold.

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When there is a sale or exchange of 50% or more of the aggregate interests in company profits and capital, however, the situation could be quite different. If there are two or more owners after the termination, a new company is formed for tax purposes on the date of the sale.

Example 23. On April 16, 2001, the MAG Partnership has three equal partners, Mary, Alvin, and Grace, all of whom have been equal partners for several years. On April 17, 2001, Mary sells her 1/3 interest in MAG to Floyd. On March 31, 2002, Alvin sells his 1/3 interest in MAG to Chris. Since Alvin's sale culminates the exchange of 2/3 of the partnership capital and profits interests within a 12 month period, MAG is considered to be terminated on March 31, 2002. Grace, Floyd and Chris are now partners in a new partnership.

The termination of the company does not necessarily cause any immediate adverse tax consequences to any of the owners. The termination is treated as a fictional distribution of all of the company assets to the owners, followed by a contribution of the assets from the owners to the new company. Since the fictional distribution would be made in accordance with the owners' capital ratios, it would not affect the distributive share of any owner's interest in the company's hot assets. Therefore, no part of the fictional distribution would be recharacterized as a sale under I.R.C. §751(b). Each owner would be considered to assume his or her proportionate share of company liabilities as part of the distribution, so that there would be no liability relief under I.R.C. §752(b). It would be a rare, if even possible, situation in which an owner would recognize any gain as a result of the hypothetical distribution of assets when the company terminates.

The company would suffer some collateral consequences as the result of the termination. It would lose its fiscal year, and the new company would need to select a permitted year. The new company would also need to make all appropriate tax elections, such as accounting methods. It might also need to establish a new basis in all of the company property.

- The new company is treated as if the owners received, and then immediately contributed all of the assets of the old company to the new company [Treas. Reg. §1.708-1(b)(2)(iv)(l)].
- Thus the company must revalue all owners' capital accounts at the time the new company comes into existence.

TERMINATION AS A RESULT OF GIFT §1.704-1(b)(2)(iv)(l)

A company would not generally terminate as a result of the gift of a capital interest. The termination rule requires that there must be a **sale or exchange** of 50% or more of the company capital and profits interests. The assumption of liabilities may be treated as a sale in a gift context, but there would nevertheless be a gift of the capital interest.

Example 24. Bob owns a 60% interest in Bobmar, LLC. He gives his entire interest to his daughter Mary. Mary would step into Bob's portion of Bobmar's liabilities, and thus the transfer would be part sale to that extent. However, the parties should take the position that Bob's capital interest was a gift to Mary. Thus there has not been a sale or exchange of any capital interest in Bobmar.

However, there would be a termination if a person gifted his interest to the only other member. At that point there would no longer be two or more owners.

RELATIONSHIP OF GUARANTEED PAYMENTS TO THE I.R.C. §179 DEDUCTION

ASSET EXPENSING UNDER I.R.C. §179

The company and each of its owners are subject to all of the limits of I.R.C. §179 [Treas. Reg. §1.179-2(d)]. These limitations are generally applied at both the company level and then again at the owner level.

The limitations are maximum expensing of $17,500 per year, before the Small Business Job Protection Act of 1996. The Small Business Job Protection Act of 1996 increased the limit as follows:

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If the taxable year begins in:	The applicable amount is:
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001 or 2002	$24,000
2003 or thereafter	$25,000

The I.R.C. §179 deduction is limited to taxable income before the I.R.C. §179 deduction and compensation (i.e., guaranteed payments) to the owners. As a result, the company is limited in the amount of I.R.C. §179 deduction that it can pass through to its owners by the net taxable income from all trades or businesses that it operates. Similarly, an owner is limited in the amount of I.R.C. §179 deduction that it can deduct by the net taxable income from *all* businesses (i.e., the aggregate taxable income). Any I.R.C. §179 expensing not deductible for this purpose may be carried over until the taxpayer has sufficient taxable income. The I.R.C. §179 deduction is reduced $1 for each $1 of eligible property placed in service that exceeds $200,000. For this purpose, the amount placed in service by one trade or business is *not aggregated* with that of another business [Treas. Reg. §1.179-2(c)(2), also see *Hayden v. Commissioner,* 204 F. 3d 772 (7th Cir. 2000).

The statutory limit applies at both the company level and the owner level. The simultaneous application of the limit to company and each of its owners may seem redundant, since no person can own more than 100% of an enterprise. If, however, any of the owners also owns interests in other pass-through entities, the expensing election by a company may create a trap. If the owner also received allocations of I.R.C. §179 expensing from other partnerships, limited liability companies and S corporations, he or she might exceed the year's total limitation.

The owner should not be able to claim a deduction that exceeds the statutory maximum for the year. However, the owner must reduce his or her basis by the amount of the expensing, whether or not it is deductible on the owner's return.

GUARANTEED PAYMENTS TO OWNERS

A guaranteed payment may be used to compensate an owner for capital or services. A guaranteed payment is a payment to the owner, in owner capacity, but not determined by reference to the company's income [I.R.C. §707(c)].

A guaranteed payment, unless it is required to be capitalized, creates an ordinary deduction to the company. It will also reduce the self-employment income reportable by other owners. Accordingly, a guaranteed payment may actually change the characterization of income to the recipient and to the company.

A guaranteed payment for services is subject to the limitations on compensation. I.R.C. §162(a) limits a deduction for compensation which is "reasonable in amount." Usually, this limitation is enforced against C corporations, since they may use compensation schemes to avoid double taxation. However, the Tax Court has held that a guaranteed payment to an owner is also subject to the same tests. Thus where a company was unable to substantiate the services performed, the deduction for a guaranteed payment has been disallowed at the company level [*River City Ranches #4 J.V v. Commissioner,* TC Memo 1999-209]. Nevertheless, the recipient owner must report the payment as ordinary, self-employment income.

INTERACTION OF GUARANTEED PAYMENTS AND THE I.R.C. §179 DEDUCTION

The taxable income limitation applies at the company level. However, it is determined before deducting any guaranteed payments to owners [Treas. Reg. §1.179-2(c)(2)(iv)]. Therefore, the presence, absence or amount of guaranteed payments will not affect the ability of the company to claim the I.R.C. §179 expensing election. However, the owners who do not receive guaranteed payments may lose a portion of their shares of the income of the company. In this case they may be unable to claim their portions of the company's expensing election, due to their own limitations.

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