Chapter 5: Partnerships

5

Corrections were made to this workbook through January of 2007. No subsequent modifications were made.

Tax professionals agree that the Internal Revenue Code and Regulations for partnerships are some of the most confusing in our tax system. It is impossible to provide a comprehensive analysis of all of the applicable provisions in just one chapter. However, this chapter attempts to address those issues most applicable for preparers. If there are multiple ways to arrive at a result, only one is chosen in the examples. This does not mean the solution provides the best result in all situations. If other computations are available, they are described in a boxed note following the example. Also, as the total amount of income subject to self-employment (SE) tax continues to increase, many proprietors are instead considering S corporation status, which allows them to take distributions instead of salary to avoid this tax.

FORMATION

PARTNERSHIP DEFINED AND WHEN TO FILE FORM 1065

Definition

The law is not very helpful in defining a partnership. It states: "For purposes of this subtitle, the term **partnership** includes a syndicate, group, pool, joint venture or other unincorporated organization through . . . which any business, financial operation, or venture is carried on, and which is not . . . a corporation or a trust or estate."[1] Furthermore, state law does not necessarily determine whether a "partnership" exists for federal tax purposes. Instead, it is the **intent** of the involved parties which determines the matter. Nevertheless, the regulations clearly state that "mere co-ownership of property that is maintained, kept in repair, and rented or leased does **not** constitute a separate entity for federal tax purposes."[2]

Example 1. Rental of Farm Land. If farm property is leased to another farmer for a share of the crops, a separate entity (partnership) is not usually created for federal income tax purposes.

1. IRC §761(a)
2. Treas. Reg. §301.7701-1

Example 2. Co-Ownership of Real Estate. Two unrelated individuals each own an undivided interest in an apartment building as tenants-in-common and the title to the property is recorded as such at the local courthouse. The tenants have all signed 12-month leases and other than customary services provided to tenants, such as snow and trash removal and general maintenance of the common areas, no significant personal services are provided. Under these circumstances, there is no need to file Form 1065, *U.S. Return of Partnership Income*. Instead, each owner reports his respective share of the gross rents received, along with expenses incurred on the property for the tax year in question on Schedule E, page 1.

Observation. If the apartment building co-owners offered other "significant personal services" to their tenants, either directly or through an agent, a partnership was probably created for tax purposes.[3] Therefore, they would report this as a business on page 1 of Form 1065. Activities without such services are reported on Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation.*

Example 3. Co-Ownership of Real Estate. Use the same facts as in **Example 2** except, in order to provide some limited liability protection, the two individual owners decide to form an LLC and transfer title of the building into this newly formed entity. The deed is recorded at the local courthouse in the LLC's name. This is the only asset the LLC owns. A Form SS-4 is filed with the IRS, giving the entity its own federal tax ID number.

Question 3. Must a Form 1065 be filed?

Answer 3. The owners of the LLC have a choice. They can file Form 1065, or they can elect out of the partnership rules by filing a statement with their first Form 1065.

Observation. If there are numerous LLC members and the entity has title to multiple properties, then it may be easier to file Form 1065. In this instance, the election out of partnership treatment is not made.

Electing Out

Some taxpayers may want to own property jointly but not file Form 1065. Also, filing a federal 1065 may create a responsibility to file a state partnership return. This might cause the net income to be taxed at a higher rate than it would have been taxed on their individual returns. Filing Form 1065 may prevent a partner from taking advantage of the like-kind exchange rules offered by §1031. Property must first be distributed out of the partnership and retitled into the names of the partners as tenants in common if not all owners want to participate in a like-kind exchange.

IRC §761(a) permits an election out of partnership treatment "if the income of the members of the organization may be adequately determined without the computation of partnership taxable income" such as the filing of Form 1065.

The following rules apply when electing out of a partnership:[4]

- The election must be timely filed. It does not necessarily have to be filed with the first Form 1065, however, the election is effective only on a prospective basis once it is properly filed.
- Consent by all owners is **assumed,** unless any dissenting owner notifies the IRS within 90 days of the partnership's formation and notifies all other partners of his desire to dissent, and
- The election is irrevocable without IRS's consent.

3. Rev. Rul. 75-374
4. Treas. Reg. §1.761-2(b)

An unincorporated organization may make an explicit election at any time during its life in a statement that is attached to, or incorporated into, a properly executed and timely filed Form 1065. This election should include:[5]

- The name, or other identification, and address of the organization;
- The names, addresses, and identification numbers of all members in the organization;
- A statement that the organization qualifies on the basis of one of the elect-out provisions;
- A statement that all members elect to be excluded from Subchapter K; and
- A statement indicating the location of the organizational agreement or, if the agreement is oral, from whom the provisions of the agreement may be obtained.

This method is particularly valuable since it allows a partnership to elect out when partnership status becomes inconvenient, even if the entity had filed partnership returns and been taxed under Subchapter K for several years.

If the partnership fails to file the election, there are regulations allowing a deemed election.[6]

Determination of Partnership Status

In situations involving more than co-ownership of property, case law is used to determine whether the parties intend to carry on the business as a partnership for tax purposes. In *Commr. v. Tower*,[7] the Supreme Court based its determination on the following factors:

1. Parties' intent to carry on a trade or business
2. Joint ownership of capital
3. Joint contribution of capital and services
4. Actual sharing of business profits and losses
5. Separate books and records maintained for the business
6. Joint control over the day-to-day business operations
7. Holding out the business as a partnership to outside third parties
8. Filing tax returns and statements as a partnership (Form 1065)
9. Operation of the business in a partnership name

A partnership does **not** exist, however, where there is a mere sharing of expenses.[8]

Example 4. Sharing of Expenses. Two individuals own property which has a common boundary. They decide to build a drainage ditch along one edge of the property and share the construction costs, as well as any expenses pertaining to the ditch's upkeep. In this situation, the mere sharing of the expenses does not constitute a partnership.

Example 5. Sharing of Office Overhead. A group of accountants decide to share office space but each maintains his own client base, billing system, and accounts receivable. However, they split the costs for the receptionist, office equipment, and office rent. Absent other factors, this scenario does not constitute a partnership for tax purposes.

---

5. Treas. Regs. §§1.761-2(b)(2) and (3)
6. Treas. Reg. §1.761-2(b)(2)(ii)
7. *Commr. v. Tower*, 327 U.S. 280, 45-1 USTC ¶9246, February 25, 1946
8. Treas. Reg. §1.761-1

Form 1065 Requirements

Form 1065 is used to report partnership income and expenses. If an organization is found to be a partnership for tax purposes, but fails to file Form 1065, the IRS is permitted to assess a fine of $50 per partner per month for a maximum of five months.[9]

A partnership that fails to file a required Form 1065 may nonetheless avoid the imposition of the penalty if it meets these requirements:[10]

1. The partnership is a domestic entity,
2. The partnership has 10 or fewer partners who are all individuals or estates,
3. Each partner's share of capital, profits and losses is pro rata,
4. The partnership is not a member of a tiered arrangement, and
5. The partners each fully report their respective shares of partnership items on their timely filed income tax returns.

> **Caution.** When real property is held as tenants-in-common (TIC) by the partners, and Form 1065 is used to report the income and expense of the real estate property, the IRS may construe the property as partnership owned. This may prevent a partner from participating in an IRC §1031 like-kind exchange with the proceeds from their portion of the property.

"CHECK-THE-BOX" ELECTION

Business entities with two or more owners (other than those classified as corporations for federal tax purposes under applicable state law) may **elect** to be taxed as either a partnership or a corporation. LLCs with a single owner can also elect to be taxed as a corporation.

Both the Treasury Department and the IRS determined it "was appropriate to replace the increasingly formalistic rules such as entity classification under the current regulations with a simpler approach that generally is elective." These rules are labeled "check-the-box" regulations.[11]

Eligible entities can secure default classification as either a partnership or as a nonrecognized separate entity without the need to file a special election:

- Domestic eligible entities with **two or more members default to partnership** status unless an election is made to be classified as a corporation. **Single-owner** entities **default to nonrecognition** as a separate entity unless an election is made to be taxed as a corporation.
- Eligible entities choosing to elect a specific classification for federal tax purposes, such as not relying on the default classification or requesting a change in classification, are required to file an election on Form 8832, *Entity Classification Election*, with the appropriate IRS service center. This is attached to their federal tax return filed for the year in which the election is effective.

It is increasingly common, especially for single-member limited liability companies (SMLLC), to forgo the formal process of obtaining a corporate charter, issuing stock, and employing the services of an attorney to form a corporation. Instead, if they qualify as an SMLLC under the applicable state statute, all that is needed is to file Form 2553, *Election by a Small Business Corporation*. They may have to pay a nominal filing fee. However, they do not need to file any organizational papers, because there is only one owner. Also, there is no need to file a Form 8832.

9. IRC §6698
10. Rev. Proc. 84-35
11. Treas. Reg. §301.7701-1

Note. Existing eligible entities which already have a federal EIN retain this number even if an election is made to change their classification.

Caution. The IRS is currently considering a requirement that a new EIN be obtained by single-member limited liability companies (Schedule C or F) which choose to change their classification from a proprietorship to a corporation. This would be the case even if the business already has employees and therefore an EIN. Also, if a Schedule C or F business decides to obtain status as a SMLLC under applicable state law, it will be required to get a new EIN.

Late S Corporation Elections

Below is a discussion of the relief possible should an entity fail to file its S election on a timely basis.

An entity **may request relief** if the following requirements are met:[12]

1. The taxpayer is **eligible** for S corporation status.[13]
2. The entity intends to be classified as a corporation as of the intended effective date of the S corporation election.
3. The entity fails to qualify as a corporation **solely** because Form 8832 was **not** timely filed[14] or was not deemed to have been filed.[15]
4. The entity fails to qualify as an S corporation on the intended effective date solely because the Form 2553 S corporation election was not filed timely.[16]
5. The entity has reasonable cause for its failure to timely file the S corporation election and the entity classification election.

The entity **seeking relief** must also meet certain procedural requirements:

1. The corporation must file a properly completed Form 2553 within six months after the due date for the tax return, excluding extensions, for the first year the entity intends to be an S corporation.
2. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 2004-48."
3. A statement explaining the reason for the failure to timely file the S corporation election and a statement explaining the reason for the failure to timely file must be attached to Form 2553.

Upon receipt of a completed application requesting relief, the IRS determines whether the requirements for granting additional time to file the elections was satisfied and notifies the entity of the result. However, an entity receiving relief is treated as having made an election to be classified as an association taxable as a corporation[17] as of the effective date of the S corporation election.

This relief may be especially important for SMLLCs that wish to be taxed as S corporations but failed to file either the Form 8832 (check-the-box election), or the Form 2553 (S corporation election). Technically, only the Form 2553 needs to be filed to obtain corporate status since it is obvious that this is the taxpayer's intent without the need to also file a Form 8832.

12. Rev. Proc. 2004-48, July 19, 2004
13. Treas. Reg. §301.7701-3(a)
14. Treas. Reg. §301.7701-3(c)(1)(i)
15. Treas. Reg. §301.7701-3T(c)(1)(v)(C)
16. IRC §1362(b)
17. Treas. Reg. §301.7701-3(c)

CONTRIBUTED PROPERTY

Partnership interests are acquired in a variety of ways. Besides the possibility of inheriting, or being gifted an interest, an interest can be obtained through a contribution of either cash or services. However, when a partnership interest is acquired through the **contribution of property,** special rules apply. These rules usually come into play because the property being contributed rarely has an adjusted tax basis at the time of contribution equal to the property's FMV. The regulations describe the adjusted basis as "the adjusted tax basis." The FMV at the time of contribution is described as "the book value." This avoids confusion with the FMV at a later time. These terms are used throughout this chapter.

There are special rules for dealing with property contributed to a partnership. These rules are contained in IRC §704, which controls the allocation of income, gain, loss, deduction, or credit. It states the allocation must be in accordance with the partner's interest in the partnership.

DEPRECIABLE PROPERTY

Generally, if there is **no recognition** on the transfer of property, then the property's adjusted tax basis at the time of transfer is carried over to the entity. Only a partnership interest is received by the contributing partner and no boot in the form of cash or other property is received. Form 4562, *Depreciation and Amortization,* is literally taken over by the partnership, which **"steps into the shoes"** of the contributing partner. Consequently, the partnership continues with the same lives and methods as those used in the past.

> **Note.** Specific tax-deferred transfers result in "shoes" depreciation being used by the transferee.[18] The specific types of transfers covered included those made under §332 (liquidation of a subsidiary into a parent corporation); §351 (tax-free incorporations); §361 (tax-free reorganizations); §721 (property transfers into partnerships); and §731 (property distributions from a partnership to a partner). As stated in IRS Notice 2000-4, the IRS added this option for qualified replacement property received in a §1031 like-kind exchange or in a casualty/condemnation situation covered under §1033.[19]

However, **if gain occurs** on a transaction otherwise governed by §721 because the contributing partner also receives some form of boot in the transfer, the property in the hands of the partnership has a **split basis** for depreciation purposes. In this situation, there is deemed to be both a tax-deferred transfer and a sale. The adjusted tax basis is **bifurcated,** with part of it being carried over and used by the partnership. The remaining portion of the transferred asset's adjusted tax basis is used to determine the gain, if any, recognized on the transfer. This split basis is determined by the relative FMV of the boot, such as property or cash received versus the FMV of the partnership interest received.

Example 6. Transfer of Nondepreciable Property with No Boot Received. An individual transfers unimproved land with a basis of $50,000 and a FMV of $100,000 to a partnership solely in exchange for a partnership interest. No gain or loss is recognized by either the contributing partner or the partnership.[20] The partner's basis in the partnership interest received is the same as the basis of the land transferred to the entity which is $50,000.[21] The partnership has a carryover basis of $50,000 in the land.[22]

18. IRC §168(i)(7)
19. The provisions of Notice 2000-4 have now been incorporated into Temp. Reg. §1.168(i)-6T(c)(5).
20. IRC §721
21. IRC §722
22. IRC §723

Example 7. Transfer of Depreciable Property with No Boot Received. An individual transfers a residential apartment building with a basis of $250,000 and a FMV of $500,000 to a partnership solely in exchange for a partnership interest. No gain or loss is recognized by either the contributing partner or the partnership.[23] The partner's basis in the partnership interest received is the same as the basis of the building transferred to the entity, which is $250,000.[24] The partnership has a carryover basis of $250,000 as well.[25] Finally, since there is no boot received in the transaction by the contributing partner and therefore no gain recognized, the partnership simply takes over the Form 4562 and "steps into the shoes" of this partner as to the depreciable recovery period and method.

Note. Since residential real estate was transferred, a 27.5-year recovery period continues to be used with the straight-line (S/L) method. The mid-month convention is used to split the depreciation for the year of the transfer.

Example 8. Calculation of Depreciation on Transfer of Property. Use the same facts as **Example 7**. The transfer is made on July 1, and both the contributing partner and the partnership are on a calendar tax year. For the year of the transfer, using the mid-month convention, the contributing partner takes 6.5 months of depreciation, January–June, plus a half month for July. The partnership uses the adjusted tax basis of this transferred property reduced by the 6.5 months of depreciation taken by the contributing partner, and recovers the remaining 5.5 months through December 31 using the same 27.5-year life and straight-line (S/L) method.

Example 9. Transfer of Depreciable Property to a Partnership with Receipt of Boot. An individual transfers a commercial building with a basis of $500,000 and a FMV of $1 million in exchange for a partnership interest worth $500,000 and $500,000 of cash. Half of the property, based on the relative FMV of the boot received versus the partnership interest received, is considered transferred for the partnership interest.[26] Therefore, the contributing partner has a substituted basis in the partnership interest equal to $250,000 or 50% of the property's adjusted tax basis at the point of the transfer.[27] The partnership has a carryover basis in this portion of the property also equal to $250,000.[28] However, the result is different for the other half of the property's value, which is treated as being transferred in a taxable exchange. The boot of $500,000 is compared to the $250,000 adjusted basis of that portion of the property with a resulting gain recognized by the contributing partner. Because the partnership is treated as having purchased half the building for $500,000, the building uses this cost basis in that portion, bringing the building's total basis to the entity to $750,000.

Partnership Balance Sheet after Transfer

	Basis	FMV
½ building	$250,000	$500,000
½ building	500,000	500,000
Total	$750,000	$1,000,000

Because of the boot received, the contributing partner recognizes $250,000 ($500,000 – $250,000 basis) gain on the transfer. He also has a basis in his new partnership interest of $250,000.

23. IRC §721
24. IRC §722
25. IRC §723
26. IRC §721
27. IRC §722
28. IRC §723

Example 10. Calculation of Depreciation on Transfer of Property with Receipt of Boot. Use the same facts as **Example 9**. The partnership's basis for the commercial building is $750,000. For the $250,000 carryover basis, the partnership "steps into the shoes" of the contributing partner and continues the same recovery period and depreciation method as the contributing partner was using prior to the transfer (39 years and S/L method). As in **Example 3,** the mid-month convention is used and the 12 months of depreciation for the tax year of the transfer is prorated accordingly. For the $500,000 increased basis resulting from the partnership's purchase of half the building, the partnership takes a "fresh start" approach when calculating depreciation, treating that portion of the property as if newly purchased. Consequently, it takes a new 39-year recovery period and uses the S/L method.

Observation. A gain might result from the transfer of heavily leveraged realty, such as property with a sizable mortgage as of the date of transfer. Taxpayers must be careful when contributing encumbered property to a partnership. This is the case even when the debt is secured solely by the property and is a nonrecourse debt, and the taxpayers are only receiving a partnership interest in return. Because of the impact of §752(b), this deemed relief from at least the part of the liability that attaches to the property might be treated as equivalent to cash being received by the contributing partner.

PROFIT VERSUS CAPITAL INTEREST

The IRS distinguishes between a profits interest and a capital interest in a partnership. A **profits interest** entitles the partner to share only in the future profits of the partnership. A **capital interest** entitles the partner to share in a distribution of partnership assets upon liquidation of the entity.

No gain or loss is recognized by the partner or the partnership as long as "property" is given in exchange for a partnership interest.[29] This applies whether the contribution of property is exchanged with an existing partnership or a newly created one.

Property is defined to include the following:

- Money
- Installment obligations[30]
- Personal note of the contributing partner[31]
- Contract negotiated by the contributing partner[32]
- Technical know-how, secret formulas, etc.[33]
- Accounts receivable
- Goodwill[34]
- Letter of intent[35]

29. IRC §721(a)
30. Treas. Reg. §1.721-1(a)
31. Rev. Rul. 68-629
32. As noted in the previous panel opinion, a taxpayer can create property by his provision of personal services.
33. Rev. Rul. 64-56
34. Rev. Rul. 70-45
35. In *United States v. Stafford,* 727 F.2d 1043 (11th Cir. 1984), a taxpayer contributed a letter of intent to a partnership in exchange for a 5% partnership interest. This letter of intent stated that the taxpayer and an insurance company had begun negotiations to finance and construct a hotel, with the insurance company providing a favorable loan and ground lease. The taxpayer contributed the letter of intent to the partnership and agreed to continue negotiations. Relying heavily on cases and rulings in the context of the formation of a corporation, the court held that the letter of intent was property within the meaning of §721 even though it gave no enforceable rights to the partnership. The court likened the letter of intent to the goodwill of a sole proprietorship.

However, the term **property** does not include services (past or future) that are exchanged for a partnership interest. A **capital** interest received in exchange for services results in immediate recognition of income to the recipient partner to the extent of the FMV of the interest received. If only a **profits** interest is received in exchange for services rendered (or to be rendered), income is recognized only to the extent of future Schedule K-1 profits allocated to that recipient partner.

The transaction in **Example 9** is considered a transfer for a capital interest in the partnership. If another person agreed to perform services for the partnership, but only received a percentage of the profits, he is considered to have a profits interest.

PRECONTRIBUTION GAIN OR LOSS, IRC §704(c)

This subsection examines the tax consequences that result when the adjusted basis of contributed property differs from its FMV on the date of transfer.

Sale versus Contribution of Property

A determination must sometimes be made as to whether a partnership interest is being "sold" in exchange for property,[36] or whether it is merely being received because of a tax-deferred contribution of property by a new or existing partner.[37]

In determining whether a sale has actually occurred, the **substance of the transaction,** rather than its form, is examined. Examples include:

- The transfer of property by the partner resulted in receipt of money or other consideration, including a promissory note which fixed the amount and time for payment. In this case, the transaction was treated as a **sale** rather than a tax-free exchange for a partnership interest.[38]
- A transaction was attempted to be shown in form as a contribution to capital, but the court ruled that its substance was really a **discharge of indebtedness** which was intended to terminate a partner's interest in a partnership.[39]

---

36. IRC §707 treats such "sales" as a transaction occurring between a partnership and a partner not acting in his capacity as a partner. In other words, it is viewed the same as if an unrelated third party was making a sale of the property to the entity.

37. Treated as a tax-deferred exchange under §721

38. Treas. Reg. §1.721-1(a)

39. *Twenty Mile Joint Venture v. Commr.*, No. 97-9003 (10th Cir., 1999); *Mas One Ltd. Partnership v. U.S.*, No. 03-4188 (6th Cir., 2004) where the payoff of a partnership mortgage loan by a limited partner was rejected as a contribution to an entity's capital.

Property Basis Differs from FMV[40]

The regulations require that any income, gain, loss, or deduction relating to property contributed to the partnership be allocated among partners. The allocation must take into account any variation between the adjusted tax basis of the property and its book value.[41]

Example 11. Appreciated Land Contributed for Partnership Interest. A partnership has three equal partners: Alex, Betty, and Carl. Alex owns land held for investment that has an adjusted tax basis of $50,000 and a book value of $250,000. Alex contributes it to the partnership in exchange for a partnership interest. IRC §721 controls this transaction. The partnership continues to hold the land for several years as an investment. It eventually sells the land to an unrelated third-party developer for $400,000.

Question 11. How is the gain on the sale allocated to the respective partners and what is its character?

Answer 11. The realized and recognized gain is $350,000 ($400,000 sales price – $50,000 adjusted tax basis). The first $200,000 of gain is allocated solely to Alex. This is the **precontribution gain** ($250,000 book value – $50,000 adjusted tax basis) which existed at the time the property was contributed to the partnership. The remaining $150,000 gain is allocated equally to the three partners ($50,000 each).

Allocations for Depreciable Built-in Gain Property

Deductions, such as depreciation related to contributed property, are allocated among partners to take into account any variation between the property's adjusted tax basis and its book value. This situation might occur when a real estate investment partnership is formed and one of the partners contributes a depreciable building with a book value greater than its adjusted tax basis, and the other partner contributes cash.

- Must any gain which results from the precontribution appreciation be allocated back to the contributing partner if the entity disposes of the property in a taxable transaction?
- What happens with the depreciation deductions in the intervening period?

The applicable regulations provide that "any reasonable method" can be used to make this depreciation allocation. The traditional method, the traditional method with curative allocations, and the remedial allocation method can be utilized.

Example 12. Allocation of Depreciation Deductions on Precontribution Gain Property. Francine and Martha form an equal partnership. Francine contributes a depreciable asset with an adjusted tax basis of $100,000 and book value of $200,000. Martha contributes $200,000 of cash. If the depreciable asset is ever sold by the partnership, the precontribution gain of $100,000 must be allocated to Francine.

Question 12. What happens with the depreciation deductions in the interim?

Answer 12. The regulations require the use of one of the methods mentioned above.

"A reasonable method" is utilized. Martha, who only contributed cash, is allocated all the tax depreciation during the period that the partnership held the property. This results in a lowering of her partnership interest's original tax basis from $200,000 downward. To the extent of the decrease in Martha's basis, this special allocation requires a corresponding reduction in the precontribution gain that must be allocated back to Francine upon a taxable sale of the property.

---

40. Obviously, it is critical when property is contributed for a partnership interest, that some attempt be made to appraise its current FMV. A record should be kept of this amount so that the necessary special allocations can be made if the property is ever disposed.

41. IRC §704(c)(1)(A)

The balance sheet immediately after the contribution is as follows:

	Adjusted Tax Basis	Book Value
Assets		
Depreciable asset	$100,000	$200,000
Cash	200,000	200,000
Capital		
Francine	100,000	200,000
Martha	200,000	200,000

The contributed asset is depreciated over 10 years using the straight-line method. The yearly tax depreciation is $10,000, while the book depreciation is $20,000. Because the asset has a built-in gain of $100,000 at the time of contribution, the depreciation is allocated to Martha in order to bring the adjusted tax basis of her capital account in line with Francine's. The entire tax depreciation of $10,000 is allocated solely to Martha. The book depreciation is split between the two partners. Francine's built-in gain is now reduced to $90,000.

At the end of the first year, the balance sheet is as follows:

	Adjusted Tax Basis	Book Value
Assets		
Depreciable asset	$ 90,000	$180,000
Cash	200,000	200,000
Capital		
Francine	100,000	190,000
Martha	190,000	190,000

Example 13. Sale of Precontribution Gain Property Where Depreciation Has Been Specially Allocated. Use the same facts as **Example 12.** The annual depreciation deduction on the asset is equal to $10,000 per year.

If the partnership sells the depreciable asset at the beginning of the second year for $180,000, it recognizes a gain of $90,000. The entire gain must be allocated to Francine since she still has that much built-in gain.

If the property sold for $200,000, the partnership recognizes a gain of $110,000. Francine is allocated her built-in gain of $90,000 plus 50% of the additional $20,000 gain, or $100,000. Martha is allocated $10,000.

Caution. Example 13 uses the "traditional method."[42] Tax preparers should also be familiar with methods described in Treas. Regs. §§1.704-3(c) and (d), and the "ceiling rule."

Observation. One might think that **Examples 12 and 13** are out of the ordinary. However, investors are deferring significant gains on real estate by buying qualified replacement property with the monies contained in escrow accounts from like-kind exchange transactions. In some situations, additional investors are being brought into the investment with straight cash. If this replacement property is contributed to a partnership or an LLC, the §704(c) rules come into play.

42. Treas. Reg. §1.704-3(b)

Example 14. Like-Kind Exchange Money Reinvested in Real Estate. A number of investors involved in a like-kind exchange (LKE) were searching for suitable qualified replacement property during the 45-day identification period. They were approached by Don, a long-time developer. Don located a sizable parcel of land upon which an X-Mart Supercenter would be built. Sensing this was a good deal, the investors used their LKE escrow monies toward the purchase of the land. Don needed additional investors to raise the necessary capital. He located 10 other investors who were not involved in a LKE, but who had the cash to make an investment into the property. As a result of the pooling of these investment dollars, the land was purchased.

Question 14. What is the respective basis for each of the investors related to their tenant-in-common interest in the underlying land?

Answer 14. For the investors who simply reinvested monies held in a LKE escrow account, they have a carryover basis equal to that of the real estate disposed of in the LKE. For the investors contributing cash, their basis is equal to the actual amount invested.

Example 15. Use the same facts as **Example 14,** except prior to starting construction on the building to be leased to X-Mart, the investors deed their ownership interests in the land to a newly formed LLC in return for a membership interest equal to the contributed land's FMV. No other boot is received. There is precontribution gain related to the LLC's holding of the real estate. This is due to the carryover bases that the investors had from the LKE. The building has a cost basis determined by the LLC's construction costs. The building is held as §1231 property (a rental building), and as a result of the §704(c) rules, the depreciation deductions flow solely to the cash-only investors.

The regulations contain a special rule when the precontribution gain or loss results in only a slight disparity.[43] A partnership does **not** have to apply the §704(c) rules to a partner's contributions in a single year if **both** of the following requirements are met:

1. The difference between the FMV and the bases of all of the contributed properties in the aggregate is **15% or less** of the properties bases, and

2. The total disparity between the FMV and the bases for all of the properties contributed by the partner during the year does **not** exceed $20,000.

If these requirements are met, the partnership is allowed to:

1. Use any of the depreciation methods described in the regulations as if the exception did **not** apply,

2. Disregard the §704(c) rules altogether, or

3. Defer the application of the §704(c) rules until the property's disposal.

Depreciation deductions can be shared equally among partners in the interim, and not solely allocated to the noncontributing partner(s). Any gain on a taxable disposition of the property can also be shared pro rata among the partners.

Observation. In addition to any precontribution gain allocated to the partner who originally contributed the property, the character of that gain might also be subject to the depreciation recapture rules. If the property sold in **Example 13** was a building, and S/L depreciation was claimed, Francine would have a portion of the $80,000 precontribution gain recharacterized as "unrecaptured §1250 gain." This would be taxed at a 25% rate, along with the remainder of the gain being treated as a §1231 gain. Both amounts would flow to Form 4797 and then to Schedule D, assuming that there were no other §1231 losses to be netted against these gains.

43. Treas. Reg. §1.704-3(e)(1)(ii)

Property Distributions within Seven Years

Deemed Sale. If property is distributed (either directly or indirectly) by the partnership to other than the contributing partner within **seven years** of the contribution, the contributing partner is treated as recognizing gain or loss equal to the precontribution difference between the property's basis and book value. The result is as if the property had been sold in a deemed sale at its FMV at the date of the original contribution to the entity.[44]

The character of the gain or loss from this deemed sale is determined by reference to the character of the gain or loss which would result if such property were sold by the partnership to the distributee.

Appropriate adjustments are made to the adjusted tax basis of the contributing partner's interest in the partnership, because of the deemed gain or loss recognized due to these rules, as well as to the adjusted tax basis of the property distributed.

Example 16. Distribution of Precontribution Gain Property within Seven Years. Use the same facts as **Example 11,** except the land is distributed to Carl within seven years. Carl is unrelated to Alex. Such a distribution is treated as a deemed sale with the precontribution gain of $200,000 being allocated solely to Alex. Additionally, since Alex is required to pick up this deemed gain, Carl receives a corresponding step-up in basis. Carl's property now has a basis of $250,000 ($50,000 basis from the partnership which would carry over to Carl, plus the $200,000 step-up gain required to be picked up by Alex due to the distribution within seven years).

GAIN/LOSS ON SALE/EXCHANGE OF CONTRIBUTED PROPERTY

General Rules

Unrealized Receivables. Assets such as accounts receivable or depreciation recapture inherent in contributed property always generate **ordinary income** when collected or otherwise disposed of in a taxable transaction.

Example 17. Contribution of Receivables for Partnership Interest. Abe and Brett decide to combine their accounting practices. They contribute, in addition to other assets, their outstanding accounts receivable. Separate tracking must be maintained to determine which receivables are being paid for by clients who received services before the merger. This allows Abe and Brett to include on their Schedules K-1 the same amount of ordinary income (as to these particular receivables) as if they kept their practices separate. Any receivables generated by services performed after the date of merger is shared based on their partnership agreement.

Inventory. Dispositions of property that is considered inventory in the hands of the contributing partner results in ordinary income or loss to the entity if sold within **five years** of the original date of contribution.

Example 18. Sale of Inventory. Gary is a long-time real estate developer who held a large parcel of appreciated land. He started the development of this particular parcel by applying for a zoning variance and sending a representative to the local municipal hearings. After a downturn in the economy, Gary decided to hold the land for investment. A year later, he contributed the land to a partnership in exchange for an interest in the entity. The partnership sold the land two years later after holding the land for investment purposes.

Question 18. What is the character of the gain?

Answer 18. Although Gary successfully converted the holding of the parcel back into an investment, it was sold by the partnership within five years of the time that it was held for development purposes. Therefore, all the gain from the sale stemming from appreciation that occurred when both Gary and the partnership held the property is taxed as ordinary income.

---

44. IRC §704(c)(1)(B)

Capital Assets with a Precontribution Capital Loss. The sale of property held as a capital asset in the hands of the contributing partner may result in a capital loss upon a subsequent disposition by the partnership within five years.[45] This is only to the extent of the unrealized loss as of the date of the original contribution.

Section 1231 Assets. Section 1231 assets include any asset used in a trade or business subject to an allowance for depreciation, as well as land used in a trade or business. Such gains are reported on Form 4797 and include unrecaptured §1250 gains which are taxed at a 25% rate.

LIABILITIES AND TRANSFERS OF CONTRIBUTED PROPERTY

General Rule

A change in a partner's share of liabilities is generally treated as a cash contribution or distribution. As a result, a partner's basis in his interest is correspondingly increased or decreased, according to the following rules:[46]

1. Basis is **increased** by:
   - An increase in a partner's share of partnership liabilities, or
   - An assumption by a partner of partnership liabilities.
2. Basis is **decreased** by:
   - A decrease in a partner's share of partnership liabilities, or
   - An assumption by the partnership of a partner's liabilities.

Contributions of Encumbered Property

When contributions of encumbered property are made in exchange for a partnership interest, care should be taken to avoid unintended gain. Any debt for which the contributing partner is considered relieved is treated the same as a cash distribution.

Example 19. Contribution of Encumbered Property Resulting in Gain to Contributing Partner. Tony is a dentist who just made extensive renovations to his clinic by borrowing on his equity in the building. Wishing to expand his practice, Tony decides to combine his practice with three other dentists by forming an LLC. They will be equal owners. Without first seeking the advice of his tax practitioner, Tony contributes the building to the new entity. He also contributes his patient base (having a zero basis). These items are contributed in exchange for a 25% interest.

At the time of the contribution, the building's adjusted basis was $150,000, with an FMV of $500,000. There was an existing mortgage of $360,000. Tony's basis in the partnership interest initially is equal to the basis of the building less the mortgage plus his share of the mortgage assumed. As a result, Tony must recognize $120,000 of gain on the transfer.

Adjusted basis of building	$150,000
Mortgage contributed	(360,000)
¼ of mortgage assumed	90,000
	($120,000)
Gain reported on transfer	120,000
Basis	$ 0

45. IRC §1237(a)

46. IRC §§752(a) or (b)

Observation. Most practitioners would advise Tony to keep the real estate outside of the dental partnership for obvious liability reasons. The net rental income received from the partnership in exchange for the use of the building will **not** be subject to SE tax. Unfortunately, when a client merely transfers title to a newly formed partnership entity without receiving any cash, he can still be required to recognize gain due to the deemed relief from the liability being assumed by the partnership.

Liability Rules and Admission of New Partners

Any increase in a partner's share of liabilities of the partnership or an increase in the partner's individual liabilities because of the assumption of liabilities by that partner is considered a contribution of money by that partner.[47]

In the following example, refinancing existing property allows new owners to buy into the partnership at a significantly reduced price, while the existing owners are able to realize appreciation on the property.

Example 20. Refinancing Real Estate Eases Admission of New LLC Members. An LLC with three equal members owns a commercial building valued at $600,000. There is no debt on the property and the members each have a basis in their LLC interest equal to $80,000.

Two additional individuals wish to buy into the LLC, but cannot afford the current admission price of $120,000 ($600,000 ÷ 5). Therefore, the LLC secures a mortgage in the form of a qualified nonrecourse debt on the property in the amount of $300,000. With the cash proceeds in hand, the LLC makes a current nonliquidating distribution of $100,000 to each of the original three members. The two new members are then able to purchase their LLC interests for just $60,000.

The outside bases of the original three members increased from their current levels of $80,000 (before the new mortgage was obtained) to $180,000.[48] When the cash distributions are made to the three members, their bases return to their original level of $80,000 each. With the admission of the two new members, the debt is shared in five equal portions. This reduces the original basis of the original three members to $40,000 (The $300,000 mortgage initially shared three ways is now shared five ways.) This results in a basis reduction of $40,000 for each to the three original members.[49]

For the original members, there is no tax effect when the decrease in the sharing of the liability (which is treated as a deemed cash distribution) caused by §752(b) occurs. This is because it lowers the bases of the three original members by $40,000. The original members have sufficient basis in their respective interests to absorb this decrease. Sharing the new liability allows the two new members to afford to buy a 20% interest in the LLC.

	Each Original Member
Beginning adjusted basis of capital interest	$ 80,000
Share of $300,000 mortgage	100,000
Cash distribution	(100,000)
Basis after admission of new partners	$ 80,000
Share of mortgage assumed by new partners	(40,000)
Basis after admission of new partners	$ 40,000

47. IRC §752(a)

48. Ibid

49. IRC §752(b)

Observation. This illustrates one of the potential advantages of a partnership/LLC when it comes to the effect of liabilities on owner basis. In comparison, S corporation debt has no effect on a shareholder's basis unless it represents a direct loan from that particular shareholder to the entity (guarantees do **not** count until such time as that owner actually has to repay the debt of the entity). In **Example 20,** as an S corporation, refinancing the property for $300,000 and then making a distribution of $100,000 results in an immediate capital gain to each of the original owners equal to $20,000 ($80,000 basis – $100,000 distribution) since the debt does **not** increase their respective bases, even if they are required to guarantee such debt (the lender requires this additional security along with the property serving as collateral).

Caution. If the mortgage was not qualified nonrecourse debt, the result might be different.[50]

Basis versus Capital Accounts

As stated above, a **partner's basis** in her partnership interest takes into account her share of the entity's liabilities. On the other hand, **capital account** does not take liabilities into account. The only exception is when encumbered property is contributed to the entity in return for a partnership interest. In this case, the contributing partner's initial basis is the substituted basis of the contributed property (its adjusted tax basis just prior to the transfer), increased by his share of the partnership debt (if any) that is allocable to the contributed property. Meanwhile, her capital account is the FMV of the contributed property, net of any liabilities.

A **partner's basis** in her partnership interest can never be negative, but it is possible that her **capital account** can be negative.

Note. Guarantees by one or more of the partners are quite common in today's business world since lenders seek to obtain the maximum protection for any monies loaned to closely held entities. In such instances, the general rule that partnership debt be shared pro rata for basis purposes is disregarded, especially in an LLC in which all members are treated as limited. This is the case when all liabilities are considered nonrecourse. Instead, the particular partner(s) who actually guarantees the debt is attributed this debt amount for basis purposes since he is bearing the economic risk of loss should the entity fail to repay the debt.

AVOIDING PRECONTRIBUTION GAIN RULES

Special rules control the distribution of property which contains a precontribution gain.[51] These rules may come into play when a taxpayer contributes high-value property and the other partners cannot afford to contribute cash or property of equal value but wish to be equal partners.

Sometimes it makes sense to sell appreciated property to a newly formed partnership or LLC instead of contributing it in exchange for an ownership interest. This is especially true in the area of real estate due to the dramatic appreciation gains that have occurred in the last five to 10 years. Of course, an investor holding appreciated raw land is free to sell the parcel to a real estate developer and only pay the 15% capital gains rate on the inherent profit. Increasingly, such investors are tempted to participate in the underlying development potential by teaming up with a company or individual who coordinates the next phase of ownership. **The key to successfully locking in the capital gain is to sell the property at an arm's-length price to the development entity.**

Note. For a good discussion of how to avoid "dealer" status with regard to real estate development or sales of individual parcels, see *Winthrop v. U.S.*[52] IRC §1237 should also be consulted for a possible safe harbor when "substantial improvements" have been made to the parcels being sold. However, it can be difficult to qualify for this latter exception, given its stringent standards.

50. IRC §465(e)

51. Treas. Reg. §1.737-1

52. *Winthrop v. U.S.,* 24 AFTR 2d 69-5760, 417 F2d 905, 69-2 USTC ¶9686 (5th Cir., 1969), October 22, 1969

Choosing the Right Type of Development Entity

A critical decision needs to be made regarding the type of tax entity to utilize for the development project. Due to the double taxation inherent in a C corporation, this is rarely the correct choice. However, is a partnership/LLC or an S corporation the best choice?

While a **partnership** offers flexibility for contributions of both cash and property and for subsequent distributions to the partners, it may not be the best choice. If the investor controls the partnership to which the property is sold, either directly or indirectly, this could produce a disastrous tax result. The law requires that ordinary income results from such sales to a controlled entity.[53] If the investor has no prior experience in the development of real estate, it is not unusual for him to team up with a seasoned developer who likely insists on controlling the project. However, when the underlying land is highly valued, the developer may not have the necessary capital to purchase a 51% or more ownership interest in the partnership.

Because §707(a)(2)(A) is so important to understanding this tax dilemma, a close reading of this provision is warranted. It states:

If — a partner performs services for a partnership or transfers property to a partnership, there is a related direct or indirect allocation and distribution to such partner, and the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).

In summary, it is treated as **ordinary income.**

As stated in §1221, it is not just the development of land into individual lots which are sold as inventory that results in ordinary income. Another problem occurs when a building is constructed on the land and then leased to an outside third party. IRC §1231 assets are also excluded from the definition of a "capital asset."

Example 21. Sale of Appreciated Real Estate to a Controlled LLC (Inventory). Barb and John are married. They bought oceanfront real estate six years ago at the Jersey seashore. During that time, the value of the parcel has tripled. A developer approaches them and offers to buy the land, intending to erect condominiums. Realizing that there is a sizable profit potential by joining forces with a developer and completing the project themselves, the couple decides to team up with a construction company and participate in the project. An LLC is formed and the property is sold at an arm's-length price to the entity.

Question 21A. What is the character of the gain if Barb and John end up owning 50% or less of the development company?

Answer 21A. Provided the couple does **not** end up controlling the development entity, either directly or indirectly, they receive **capital** gain treatment on their gain.

Question 21B. How does the answer change if they end up with control of the LLC?

Answer 21B. If they control the development company, the entire gain is treated as **ordinary** income.

Example 22. Sale of Appreciated Real Estate (§1231 Property) to a Controlled LLC. Use the same facts as **Example 21,** except instead of erecting condos (inventory), the development company intends to erect a hotel and lease it to a national chain, which will operate it for 10 years with an option to renew.

Question 22. How will this change the answer, if at all?

Answer 22. The tax dilemma presented in **Example 21** is still present. If the couple is in control of the development entity to which the land is sold, ordinary income results. Once again, under §1221, real property which is used in a trade or business is **not** considered a "capital asset." This is true even here, when a rental property is constructed on the land.

---

[53] IRC §707(b)(2)

Because of the issue with §707(b)(2), investors who wish to control the underlying entity doing the development activities need to consider locking in the capital gains potential by forming an **S corporation.** With a controlled corporation, a sale of appreciated property can still occur without the gain being recharacterized as ordinary income. The key provision in this instance is §1239. In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor is treated as ordinary income. This is the case only if such property is a type which is subject to the allowance for depreciation provided in §167 in the hands of the transferee (the development company).[54] Obviously, land is not a depreciable asset.

Example 23. Sale of Appreciated Property to a Controlled S Corporation. Use the same facts as **Examples 21 and 22**. If an S corporation instead of a partnership/LLC is used, it does not matter if condos (inventory) are built for sale to customers, or if a hotel (§1231 property) is erected and leased for an extended period of time. In either case, the couple **receives capital gain treatment** on the profit realized from the sale.

Treating the Transfer as a Sale

The key to locking in the capital gains potential on dramatically appreciated real estate is to ensure that the transfer to the development entity is actually a "sale" and not a mere contribution to capital. This is especially critical when an installment note is executed to finance the sale. Besides establishing a fair price for the underlying sale of the land, the terms of the note and its security should be the same as any outside investor would insist upon. Most importantly, everyone should adhere to the terms in the installment note. Therefore, if a payment is due under the note, the development company should make the payment regardless of their cash flow. The development entity should take steps to ensure that, in addition to having adequate funds for marketing of the lots and other costs of completing the needed infrastructure (streets, roads, curbs, utilities, etc.), construction fund loans or other capital is available for making the necessary installment payments as they come due under the note.

Note. Keep in mind that even if the client chooses to use installment reporting, the so-called "second disposition" rule causes the deferred gains, attributable to land sold by the S corporation or partnership within two years after buying it from the client, to be accelerated.[55] However, with the sale of these lots, the necessary funds should be available for payment of the note thereby giving the transferor the monies needed for the payment of any taxes due on the capital gain. Another option is to elect out of installment reporting especially when the client has sizable capital loss carryovers.

With a **sale,** as opposed to a contribution to capital, the development entity uses **FMV as its basis** in the underlying property. Therefore, with the costs of marketing and developing being added to this initial basis, only the profit above and beyond this level is treated as ordinary income which flows to the entity's owners. If a contribution to capital occurs, the entity merely has a carryover basis in the real estate with the result that all subsequent profit is treated as ordinary income. Consequently, it is very important that the transfer be structured as a sale that withstands IRS scrutiny if this later becomes an issue.

The good news is that the courts have already considered this issue in *Bradshaw*,[56] a case in which the taxpayer successfully defeated the IRS. It is critical that the client carefully document and execute the sale to the development entity. With an installment note, the **interest and principal payments must be made according to the terms** of the notes. It is also important to **take steps to completely separate the formation and capitalization of the S corporation and the sale of the land to the development entity** so these are easily viewed as distinct events. Additionally, it is important to **get the land appraised** before the sale and **charge an arm's-length price.** Finally, it might be wise not to allow the S corporation (if that is the type of entity that is ultimately used) to issue any stock to the client at the same time the land sale is made.

54. IRC §1239

55. IRC §453(e)

56. *Bradshaw, Jolana S. v. U.S.*, 50 AFTR 2d 82-5238, 683 F2d 365, 82-2 USTC 9454 (Ct. Cl., 1982), June 30, 1982

> **Observation.** If the underlying property is sold on the installment basis and subsequently disposed of by the related development entity, the proceeds received from the sale of these lots are considered payment on the note.[57] This could cause an acceleration of the installment gain.

SELF-EMPLOYMENT TAX FOR LLC MEMBERS

In 1997 the IRS issued proposed regulations on the issue of whether SE tax is due on K-1 income received by an LLC member. The IRS used the same approach as contained in the first two sets of proposed regulations, even though Congress stepped in and placed a moratorium on their release. The IRS continues to use three tests to decide whether an LLC member is treated as a "limited partner" when it comes to the imposition of SE tax. If the answer to any of these questions is "Yes," the IRS can impose SE tax on the member's K-1 earnings.[58]

1. Is the LLC member materially involved in the LLC's business activities for more than 500 hours in a given tax year?
2. Can the member bind the entity in a legally enforceable contract?
3. Is the LLC member personally liable for **any** of the entity's debt?

The third test continues to cause the most controversy because the size of the debt does not matter. This can happen when a lender requires an LLC member to serve as a guarantor of the business' debt. Even when a guarantor is not involved with the day-to-day operations of the entity, the presence of his guarantee on any entity debt is enough to allow imposition of SE tax. Since these regulations are merely proposed, many practitioners have chosen to ignore their guidance, especially with regard to LLC members who have acted as guarantors. Practitioners have proceeded to treat K-1 earnings received by these "investor" members as **not** being subject to SE tax. As demonstrated below, using other sections of the proposed regulations might provide an avenue of relief to this dilemma.

"VARYING INTERESTS" IN AN LLC

The proposed regulations define an individual who is **not** a limited partner.[59] If a limited partner has day-to-day management responsibilities for the LLC's business operations, the regulations state this member may nevertheless exclude from net earnings for SE tax purposes, a portion of that individual's distributive share if he holds **more than one class** of interest in the partnership or LLC.[60] If an individual is **not** a limited partner[61] solely because he participates in the entity's trade or business for more than 500 hours, he can still be treated as a "limited partner."[62] However, under either rule, such treatment is permitted only if the individual's distributive share is **identical** to the distributive shares of the partners who qualify as limited partners[63] and who own "a substantial, continuing interest in the entity."[64] Nevertheless, it might be more difficult under this approach to argue that earnings derived from an LLC that performs personal or professional services are **not** subject to SE tax. As a result, the proposed regulations state that if "substantially all" the activities of a partnership involve the performance of professional services, an individual member who provides those services is **not** considered a limited partner.[65] For purposes of this exception, professional services include services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[66]

---

57. IRC §453
58. Joint Committee on Taxation report, *Options to Improve Tax Compliance and Reform Tax Expenditures*, January 27, 2005
59. Prop. Treas. Reg. §1.1402(a)-2(h)(2)
60. Prop. Treas. Reg. §1.1402(a)-2(h)(3)
61. Prop. Treas. Reg. §1.1402(a)-2(h)(2)
62. Prop. Treas. Reg. §1.1402(a)-2(h)(4)
63. Prop. Treas. Reg. §1.1402(a)-2(h)(2)
64. Prop. Treas. Regs. §§1.1402(a)-2(h)(3) and 1.1402(a)-2(h)(4)
65. Prop. Treas. Reg. §1.1402(a)-2(h)(5)
66. Prop. Treas. Reg. §1.1402(a)-2(h)(6)

Observation. The approach taken by this latest set of proposed regulations is to exclude from an individual's SE tax those amounts that are demonstrably returns on capital invested in a partnership or LLC.

PLANNING ALTERNATIVES TO AVOID SE TAX

Alternative methods may be employed to avoid these tax issues:

1. **Flowing the Earnings through an S Corporation.** Form an SMLLC and make a "check-the-box" election to be treated as a corporation. Then make an S election to avoid SE tax. The SMLLC can be used to hold the LLC interest in a service-type business with the K-1 flowing through it first, and then earnings are treated only partially as "salary," with the rest as a distribution from the S corporation.

Caution. It is always possible that the IRS will attack such arrangements, especially if an "unreasonably low" salary is paid to the shareholder.[67] However, the Tax Court upheld the validity of this arrangement due to a valid business purpose for the structure.[68]

2. **Income Splitting among Family Members.** Assuming a professional license is **not** required to be involved in the LLC's business activity, another alternative is to transfer a percentage of the LLC's ownership to a spouse, or a child who is **not** subject to the "kiddie tax." The spouse or child **cannot** be involved in the day-to-day operation of the LLC's business. The K-1 income flowing through to the spouse or child is **not** subject to SE tax. The key to this approach is that the LLC's other owners, who manage the business and perform the necessary services on its behalf, receive a reasonable guaranteed payment commensurate to the time they devote to the LLC's operations. If the spouse or child performs services for the LLC, the family partnership rules contained in §704(e) might apply. This requires recharacterization of some of the earnings flowing to the other family members as earnings that should be paid to the service-providing spouse or family member.

Example 24. Using the Varying Interest Rule to Avoid SE Tax. Angela, Barbra, and Connie form an LLC to engage in a non-service business. The LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of the LLC to the three members in proportion to their ownership. Angela and Connie each contribute $1,000 for one LLC unit. Barbra contributes $2,000 for two LLC units. Each LLC unit entitles its holder to receive 25% of the LLC's tax items, including profits. Angela does not perform services for LLC. Each year, Barbra receives a guaranteed payment of $6,000 for 600 hours of services rendered to the LLC. Connie receives a guaranteed payment of $10,000 for 1,000 hours of services rendered to the LLC. Connie is the LLC's manager. Under the applicable state's law, Connie has the authority to contract on the LLC's behalf.

In this scenario, Angela is treated as a limited partner in the LLC[69] because she is not personally liable for debts of or claims against the LLC. Angela does not have authority to contract for the LLC under state's law, and she does not participate in the LLC's trade or business for more than 500 hours during the taxable year. Therefore, Angela's distributive share attributable to her LLC unit is excluded from net earnings from self-employment.[70]

---

67. *Gray Public Accountant, P.C. v. Commr.*, Nos. 02-4417, 03-2756 & 03-2757 (3rd Cir.), March 23, 2004; *Nu-Look Design, Inc. v. Commr.*, No. 03-1713 (S.Ct.), February 26, 2003

68. *Grigoraci v. Commr.*, TC Memo 2002-202, August 12, 2002

69. Prop. Treas. Reg. §1.1402(a)-2(h)(2)

70. Treas. Reg. §1402(a)(13)

Barbra's guaranteed payment of $6,000 is included in her net earnings from self-employment under §1402(a)(13).[71] Regarding other income flowing through to her on her K-1, she is **not** treated as a limited partner[72] because she participates in the LLC's trade or business for more than 500 hours during the taxable year. Barbra is not liable for debts or claims against the LLC and she does not have authority to contract for the LLC under state law. Furthermore, Barbra is not treated as a limited partner[73] because she does not hold more than one class of interest in the LLC.

Nevertheless, Barbra is still treated as a limited partner under Prop. Treas. Reg. §1.1402(a)-2(h)(4). But she is not treated as a limited partner under Prop. Reg. §1.1402(a)-2(h)(2) solely because she participated in the LLC's business for more than 500 hours and because Angela is a limited partner under Prop. Reg. §1.1402(a)-2(h)(2) who owns a "substantial interest" with rights and obligations that are identical to Barbra's rights and obligations. In this example, Barbra's distributive share is deemed to be a "return on her investment" in the LLC and not remuneration for any services she renders to the LLC. Thus, Barbra's distributive share attributable to her two LLC units are not treated as net earnings from self-employment under §1402(a)(13).

Finally, Connie's guaranteed payment of $10,000 is included in her net earnings from self-employment.[74] In addition, her distributive share attributable to her LLC unit is considered net earnings from self-employment because she is not a limited partner.[75] Connie is not treated as a limited partner[76] because she has the authority under state's law to enter into a binding contract on behalf of the LLC and because she participates in the LLC's trade or business for more than 500 hours during the taxable year. Furthermore, Connie is not treated as a limited partner[77] because she does not hold more than one class of interest in the LLC. Also, she is not treated as a limited partner[78] because she has the power to bind the LLC into legally enforceable contracts. Consequently, both Connie's guaranteed payment and distributive share are included in her net earnings from self-employment.

Observation. Lawyers drafting operating agreements for LLCs have recently revised these documents to provide for "varying interests" in the entity. Some call the interests "managing member" interests versus "investor interests," while others use the terms "Class A" versus "Class B" interests. The attempt is to give the LLC members who manage the entity on a day-to-day basis a small percentage as a "Class A" interest, and the remainder of their ownership as a "Class B" interest. The intent is to provide tax guaranteed payments received for services, along with their "Class A" interest as SE income, while their "Class B" interest represents a "return on investment" in the LLC. This is similar to what occurred with limited partnerships in the past. In this case, a general partner could simultaneously hold his general partnership interest, which is subject to SE tax along with any guaranteed payments received, and a limited partnership interest which is excluded from SE income.

71. Prop. Treas. Reg. §1.1402(a)-2(h)(4)

72. Prop. Treas. Reg. §1.1402(a)-2(h)(2)

73. Prop. Treas. Reg. §1.1402(a)-2(h)(3)

74. IRC §1402(a)

75. Prop. Treas. Regs. §§1.1402(a)-2(h)(2), (3) or (4)

76. Prop. Treas. Reg. §1.1402(a)-2(h)(2)

77. Prop. Treas. Reg. §1.1402(a)-2(h)(3)

78. Prop. Treas. Reg. §1.1402(a)-2(h)(4)

Effective Date. The proposed regulations have never been adopted. In the 1997 Budget Reconciliation 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 regulations on this matter before July 1, 1998.[79] There were two bills introduced in 2002 that would have modernized the code to explicitly deal with LLC members. However, neither of these were enacted. As of mid-2006, the IRS has not taken any further action on this matter.

> **Note.** LLC operation agreements should be reviewed and possibly modified to take advantage of this "varying interest" rule. In this regard, the examples in the previous section should be carefully studied for possibly avoiding SE tax, even for managing members of LLCs.

BASIS, AT-RISK LIMITATIONS, AND PASSIVE LOSS LIMITATIONS

Especially in the case of a start-up business, it is not uncommon for significant losses to flow through to the partners on their Schedules K-1. The issue is whether such losses can yield a tax benefit by offsetting other income on the partner's return. In making this determination, there are **three** separate sets of limits which can prevent the current deduction of these losses on the owner's return. They are **considered in the order that they apply** when evaluating this issue on an **annual** basis.

1. Is there sufficient basis to deduct the loss?
2. Is there enough initial basis to be considered "at risk" to cover the loss flowing through on the K-1 to the partner?
3. Is the partner "materially participating" in the underlying business of the partnership? If not, then the passive loss rules apply and prevent the current utilization of the K-1 loss.

If some or all of the loss flowing through on the partner's K-1 is a capital loss, then §1211(b) can further limit this loss to the level of the partner's capital gains, or the annual $3,000 limitation on such losses. Other limitations, such at those imposed on charitable contributions (50% or 30% of AGI), or under §163(d)(3) on investment interest expense reported on Form 4952 might come into play as well.

BASIS OF A PARTNERSHIP INTEREST

The starting point for the determination of a partner's basis is the cash paid and/or adjusted basis of any property contributed in exchange for the partnership interest. Basis is affected by the manner in which a partner acquires his interest, i.e., by means of a gift, inheritance, or purchase.

- If the partner acquired his interest through a **gift,** he uses the carryover basis from the donor, and increases the basis by any suspended passive losses which might have existed for that interest at the time of the transfer.
- If the partner acquired his interest through an **inheritance,** his basis normally is the FMV of the partnership as of the date of the deceased partner's death.
- If the partnership interest was acquired by **purchase** from another existing partner, the initial basis is the price paid for the interest.

Example 25. Basis of Partnership Acquired by Gift. Cindy's father decides to make a gift of part of a partnership interest he currently holds. At the time of the gift, the father's basis in this portion of his partnership interest is $10,000. Because he is a passive investor in this partnership and could not utilize all the flow-through losses, he also has $2,000 of suspended passive losses allocable to this portion of his interest. In this instance, Cindy has a carryover basis of $10,000, increased by the $2,000 in suspended passive losses, for an overall basis of $12,000.

79. §734 of the Senate amendment to H.R. 2014

> **Note.** If the donor has losses allocable to this gifted interest that are suspended by his overall lack of basis or the at-risk limitations **instead** of the passive loss rules, they will **not** flow over to the recipient and therefore have no effect on the initial determination of her basis in the partnership interest received. These tax attributes remain personal to the donor and stay suspended until such time that he has sufficient basis to deduct them.

Example 26. Basis of Partnership Interest Acquired by Inheritance. Use the same facts as **Example 25,** except Cindy inherits her father's interest upon his death. As of the date of his death, the partnership interest is valued at $15,000. Her father's basis in that interest immediately before he died was only $10,000. Therefore, the interest receives a $5,000 step-up in basis. At the time of death, there were $2,000 in suspended passive losses attributable to the interest. However, since the step-up of $5,000 is greater than the $2,000 in suspended passive activity losses, these "go to the grave" with the father. If the step-up to FMV was only $1,000 (the FMV was $11,000 at the time of death) then $1,000 in suspended passive losses could be used to provide a further step-up in basis to $12,000.

> **Note.** The recipient would be required to make a §754 election. This is discussed later in this chapter.

The initial basis amount is adjusted annually as of the last day of the partnership tax year[80] for subsequent contributions, distributive share of income and loss, and distributions of cash and property. The adjustments are made in the following manner and order:

1. The **basis is increased** by the sum of the partner's distributive share for the taxable year and prior taxable years for:
   - Taxable income of the partnership,[81]
   - Tax-exempt income of the partnership, and
   - The excess of the deductions for depletion over the basis of the property subject to depletion.
2. The **basis is decreased** (but not below zero) by distributions made by the partnership[82] and by the sum of the distributive share for the taxable year and prior taxable years for:
   - Losses of the partnership, both separately stated and nonseparately stated;
   - Expenditures of the partnership not deductible in computing its taxable income, and not properly chargeable to capital account;[83] and
   - The amount of the partner's deduction for depletion for any partnership oil and gas property, to the extent the deduction does not exceed the proportionate share of the adjusted basis of the property allocated to the partner.[84]

What happens if a partner acquires his interest by giving the partnership a note, or a mere promise to pay a fixed amount over time for the FMV of their interest?

---

80. IRC §705(a)

81. As determined under §703(a)

82. As provided in §733

83. Examples of these expenditures include the 50% disallowance on meals and entertainment and the 100% disallowance on any dues which may have been paid by the partnership.

84. IRC §613A(c)(7)(D)

The Tax Court held when a taxpayer transfers his own note to a partnership in exchange for a partnership interest, the taxpayer acquires a zero basis in the partnership interest[85] since the taxpayer paid nothing for it at that point in time.[86] Only when principal payments are made on the note will a corresponding increase in the partnership interest basis occur.[87] In a similar fashion, regulations specifically provide that the contributing partner's capital account is increased only when principal payments are actually made on the note.[88]

PARTNERSHIP LOSSES EXCEED A PARTNER'S BASIS

The partner's distributive share of the aggregate of items of loss from separately stated items (e.g., the sale or exchange of property, capital losses, investment interest expense, and nonseparately stated losses from Form 1065, page 1, trade or business loss) may exceed the basis of the partner's interest. If this occurs, the overall limitation on losses[89] must be allocated to the partner's distributive share of **each** loss. This allocation is made by taking the proportion that each loss bears to the total of all losses. However, for this purpose, the total losses for the taxable year are the sum of the partner's distributive share of losses for the current year, as well as his losses disallowed and carried forward from prior years.[90]

Note. Keep in mind that any item which could have a varying tax effect from one partner to another must be separately stated on Schedule K-1. This includes any item which might receive special treatment or could be subject to separate limits at the owner's level, or might impact the owner's AMT calculation.

Example 27. Allocation of Losses Where Aggregate Sum Exceeds Partner's Basis. At the beginning of the year, Adam has a $3,000 basis in his partnership interest. As of the end of the current partnership tax year, Adam has the distributive share of partnership items shown below:

§1231 loss	($9,000)
Short-term capital loss	(5,000)
Nonseparately stated income	4,000

At the end of the year, Adam's basis is calculated as shown below:

Beginning basis	$3,000
Nonseparately stated income from Form 1065, Page 1	4,000
Total	$7,000

Because Adam's share of the loss exceeds his basis ($14,000 exceeds his basis of $7,000), he must prorate the losses against the basis.

	Total	Allocation	Deductible Loss	Carryover Loss
§1231 loss	($ 9,000)	($9,000 ÷ $14,000) × $7,000	($4,500)	($4,500)
Short-term capital loss	(5,000)	($5,000 ÷ $14,000) × $7,000	(2,500)	(2,500)
Total losses	($14,000)		($7,000)	($7,000)
Remaining basis			$ 0	

85. IRC §722

86. *Oden v. Commr.*, TC Memo 1981-184, aff'd in unpublished opinion, 679 F2d 885 (4th Cir. 1982), April 20, 1981

87. *Borrell v. Commr.*, TC Memo 1989-251, May 24, 1989

88. Treas. Reg. §1.704-1(b)(2)(iv)(d)(2)

89. IRC §704(d)

90. Treas. Reg. §1.704-1(d)(1)

Example 28. Carryover When Loss Exceeds Partner's Basis. As of the end of the current partnership tax year, Brenda has a $500 basis in her partnership interest. Her distributive share of nonseparately stated trade or business loss is $1,000. Because of the overall basis limitation rules, Brenda is only allowed to claim $500 ($500 basis – $1,000 loss) of the partnership's loss on her individual return. The remainder is suspended and carried over to the following tax year.

Brenda's basis in her partnership interest increases by $500 or more in the following tax year. All of the $500 suspended loss from the prior tax year is now allowed. The increase could be due to her allocable share of the partnership's separately stated or nonseparately stated items, a contribution to capital that she made, or because her share of the partnership's liabilities has increased.

Conversely, if Brenda's basis the following tax year increases by less than $500, then only that portion of the suspended loss being carried over from the prior tax year can be deducted on Schedule E, page 2. If her basis only increases by $400 in the following tax year, then only $400 of the $500 suspended loss from the prior year can be claimed. The remaining $100 of the $500 continues to be suspended until the following year, or until Brenda has sufficient basis in her partnership interest for it to become deductible.

PARTNER'S DISTRIBUTIVE SHARE AFFECT ON CAPITAL ACCOUNT

A partner's capital account, just like the basis in her partnership interest, is adjusted downward to reflect the partner's distributive share of partnership loss.[91] However, a question arises if some of the partner's distributive share is disallowed because of lack of tax basis as illustrated in the prior examples.

Question. Should the partner's capital account be adjusted only for that portion of the loss allowed?

Answer. No, her capital account reflects the economic relationships among the various partners. As a result, capital accounts adjustments **do not necessarily** track the tax information shown on Schedule K-1. Therefore, the disallowed portion of meals and entertainment or country club dues paid by the partnership still reduce a partner's capital account in full. Conversely, a partner's distributive share of tax-exempt income serves to increase her capital account in the same manner as distributive shares of taxable income, even though tax-exempt income is never included in gross income on the partners' individual tax returns.[92] These adjustments are appropriate because capital accounts are intended to correspond to the partners' agreement on how to allocate economic gain and loss.[93]

LIABILITIES CAN INCREASE BASIS

Many companies, especially in their start-up phase, must depend on borrowing to provide for their day-to-day cash flow. The borrowed monies may come directly from one or more of the individual partners. If this is the case, then the amount of debt increases the tax basis of the partner who loaned the entity the money.[94]

Partnerships and LLCs taxed as partnerships treat personal loans made to the entity differently. For a **general partnership,** the contributing partner adds the amount of the loan to his partnership basis.[95] However, the other general partners are also liable for repayment of the loan if the partnership is unable to repay. Therefore, the contributing partner's basis is reduced by the other partner's share of the loan.[96]

The individual members of an **LLC** are sheltered from the entity's liabilities. Therefore, the contributing member's personal loan only increases his basis and is not reduced because of §752(b).

91. Treas. Reg. §1.704-1(b)(2)(iv)(b)

92. Ibid

93. Treas. Reg. §1.704-1(b)(2)(ii)(a)

94. IRC §752(a)

95. IRC §752(a)

96. IRC §752(b)

The following examples are based on an LLC.

Example 29. Nonrecourse Debt and Effect on Outside Basis. If an LLC is formed and none of the members have guaranteed the debt, the debt is considered nonrecourse. This is because of the limited liability status of each of the members. Therefore, they all share equally in the debt as an additional source of basis. Assume a three member LLC and each member contributes $10,000 initially giving each member an initial basis of $10,000. If the LLC borrows $60,000, without any personal guarantees their member interest basis increases by $20,000 or ($60,000 ÷ 3). Each member has a basis of $30,000 after the loan.

Example 30. Member Loans Serve to Increase Basis in His LLC Interest. Arlo, Bryan, and Quincy form an LLC as equal owners. Each contributes $10,000 to the capital of the entity. Each has an initial basis in the membership interest of $10,000. However, being a new company, the LLC has trouble borrowing from any of the local banks. Also, neither Arlo nor Bryan can advance more money to the LLC. On the other hand, Quincy agrees to lend $60,000 to the LLC in the form of a demand loan. This debt serves to increase Quincy's basis from the initial $10,000 amount to $70,000.[97]

Example 31. Member Guarantees and Effect on Outside Basis. Use the same facts as **Example 30**, except Quincy guarantees a $60,000 loan which is made by a local bank. Neither Arlo nor Bryan agrees to guarantee the debt. Only Quincy benefits from the increase in basis due to the existence of the debt, since he is the only member who bears the economic risk of loss should the LLC fail to repay the loan.

There is a critical distinction between partnerships and S corporations as far as the effect of any entity debt and whether it serves to increase one's outside basis. For **S corporation** owners, only direct loans from the shareholder to the corporation increase basis. Therefore, a mere guarantee of S corporation debt has no effect on a particular shareholder's stock basis. The net result is that S corporations incurring losses in their start-up years are similar to regular C corporations. The shareholders can only deduct Schedule K-1 losses to the extent of their basis, even though the entity might have significant debt on its books and one or more of the owners has guaranteed that debt.[98]

FACTORS OTHER THAN BASIS

While basis is an important factor to consider when determining the amount a taxpayer may deduct, there are two other equally important factors.

1. At-risk limitation
2. Passive loss limitation

Basis, at-risk limitations, and passive loss limitations can all result in suspended losses. A major difference is that **suspended basis losses cannot** be used to reduce gain upon liquidation or disposition of the partnership interest. **Suspended at-risk and passive losses can** be used to reduce gain upon liquidation or disposition of the partnership interest.

To avoid confusion, it is important to remember that the basis amount is normally not the same as the capital account. The capital account does not change when the liabilities amount changes.

AT-RISK LIMITATIONS REDUCE LOSS DEDUCTION (IRC §465)

Even if a partner has sufficient basis to initially absorb all of the loss flowing through on his K-1, the §465 at-risk limitations can still affect the limit of the deduction. The at-risk rules limit a taxpayer's loss deduction to the amount he could actually lose from the activity.

---

97. IRC §752(a)

98. In effect, there is no equivalent of IRC §752 in Subchapter S.

Essentially, the at-risk rules affect that portion of a partner's basis which is derived from the sharing of allocable partnership liabilities if the particular partner is not "at risk" as to that debt amount. For these purposes, the guarantee of a debt puts the guarantor partner at risk since he bears the burden of repaying the debt if the partnership defaults. However, for any other **nonrecourse** debt, except for "qualified real property indebtedness," this amount is subtracted from the initial basis amount.

Therefore, a partner's amount considered **"at risk"** includes all cash invested in the partnership, the adjusted tax basis of all property contributed, and most borrowed amounts for which the taxpayer bears the economic risk of loss for its repayment if the partnership defaults. One can argue that a taxpayer's amount at risk in an investment is essentially equivalent to his adjusted tax basis in the property with one major difference. Generally, **nonrecourse loans used to increase a partner's basis do not increase a taxpayer's amount considered to be at risk.**

The §465 at-risk rules were introduced by the 1976 Tax Act in response to the rampant use of nonrecourse debt in tax shelters. Significant tax basis was generated by such debts under §752(a), thus permitting the deduction of K-1 losses far in excess of any capital contributions by the partners. Yet there was little chance that any of these partners, especially limited partners, would ever be called upon to repay these debts.

Observation. Since only **direct** shareholder loans serve to increase basis in an S corporation, and the particular shareholder that loaned the money is at-risk for these funds, the §465 at-risk rules rarely come into play to decrease the initial debt basis calculation.

There is an exception for **"qualified real property indebtedness."** Taxpayers are not considered to be "at risk" for amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or other similar arrangements.[99] As a result, where there is "no realistic possibility of economic loss," deductions are disallowed.[100]

This exception was lobbied for and eliminated from these at-risk rules in the 1986 Tax Act. The banking and real estate lobbyists successfully argued that nonrecourse debt, secured solely by real estate and made by a "qualified financial institution," as opposed to a marketer or promoter of the tax shelter, is still considered at risk even though it is unlikely that any of the owners will ever be called upon to repay the debt.

Example 32. At-Risk Rules and Nonrecourse Debt on Other-Than-Real Property Indebtedness. The partnership borrows $100,000 from a local bank. The nonrecourse debt is only secured by the equipment purchased with the borrowed funds. The individual partners' basis is initially increased by a corresponding amount.[101] However, under the §465 at-risk rules, this basis is reduced by the same amount.

Example 33. At-Risk Rules and Qualified Real Property Indebtedness. Use the same facts as **Example 32,** except the $100,000 is used as a down payment on the purchase of real estate, which is the sole source of security for the nonrecourse debt. Because of the exception created under §465 related to "qualified real property indebtedness," the basis increase created by §752(a) is not reduced by the at-risk rules, even though this is a nonrecourse debt.

Losses disallowed under the at-risk rules remain suspended until the taxpayer's at-risk investment in the activity increases or income from the activity is otherwise includible in the partner's basis.[102] Normally, this occurs no later than when the taxpayer ultimately disposes of his partnership interest in a taxable transaction.

99. IRC §465(b)(4)

100. *Whitmire v. Commr.,* 109 TC 266 (1997), aff'd, No. 98-70495 (9th Cir. 1999), October 29, 1997

101. IRC §752(a)

102. IRC §465(a)(2)

PASSIVE LOSS RULES LIMIT DEDUCTION OF K-1 LOSSES

The passive loss rules are another major hurdle in deducting K-1 losses by a partner who is only an investor. Introduced by the 1986 Tax Act, they prevent loss deductions even when the partner has sufficient basis and is considered to be at risk. Passive losses are limited to the simultaneous presence of passive income for those investor/owners who do not materially participate in the day-to-day operations of the entity.

Note. Under §469, there are seven separate ways in which a partner can **materially participate** in the entity's operations. The most common way is to devote at least 500 hours or more annually to the business operations.

Example 34. Effect of Guarantee on Member's Basis. Alice contributes $10,000 cash in exchange for an LLC interest. At the end of the first tax year, the entity borrows $50,000 which is solely guaranteed by the member.

Under the basis rules, her initial basis is $60,000 ($10,000 cash contribution and $50,000 debt allocated under §752(a)). The at-risk rules do not reduce this initial basis calculation since she is personally at risk for the repayment of the debt due to her guarantee. However, if she is a mere investor and does not materially participate in the LLC's business operations, none of the initial losses, which might be incurred in the start-up years of the business, are deductible. Instead, she must wait until the LLC generates a business profit which flows through on her Schedule K-1 to offset an equal amount of loss, or until she has sufficient passive income from other sources.

Note. Any losses suspended under the passive loss rules are listed on Form 8582, *Passive Activity Loss Limitations*, until sufficient passive income exists to take them, or the partner has disposed of his entire partnership interest in a fully taxable transaction.

To determine whether a Schedule K-1 loss is deductible, apply the following **three steps,** in order:

Step 1. Determine the member's basis in his ownership interest.

Step 2. Ascertain what amount, if any, of this initial basis is considered at risk.

Step 3. Determine whether the passive loss rules apply, and limit the loss to any passive income if the owner does not materially participate in the underlying trade or business of the LLC.

Normally, this process is an evaluation of the risk the owner might actually bear for his share of LLC liabilities allocated in Step 1 (under IRC §752(a)).

A member's basis in his ownership is important for:

1. Determining the ability to take losses that flow through on the member's K-1
2. Ascertaining the tax effect of any LLC distributions
3. Determining gain or loss on any taxable disposition of the member's interest

Certain exceptions, such as the active rental real estate exception, or the disposition rule might allow excess passive losses to be deducted.

Example 35. Keeping Track of Suspended Losses. Ben contributes $10,000 cash to an LLC and receives a 50% interest in return. At the end of the first tax year, the LLC borrows $60,000 to purchase equipment without any of the members guaranteeing the debt. Ben lends $40,000 to the LLC personally, but does not otherwise materially participate in the business operations. The LLC incurs a loss for its first tax year. Ben's distributive share of the loss is $50,000.

Question 35A. Step 1. What is Ben's **basis,** assuming no distributions are made during the year?

Answer 35A. Ben's initial basis in his LLC interest is calculated as follows:

LLC contribution	$10,000
Share of nonrecourse debt	30,000
Personal loan to LLC	40,000
Basis in LLC	$80,000

Given the loss of $50,000 on the member's K-1, Ben's $80,000 basis is sufficient to deduct the entire loss, subject to at-risk and passive-loss limitations.

Question 35B. Step 2. What part of his basis is considered **at risk?**

Answer 35B. Of Ben's $80,000 basis in his LLC interest (Step 1), only $50,000 is considered at risk for purposes of Step 2. This is because Ben bears no economic risk of loss for the nonrecourse debt of $30,000. Should the LLC ever fail to pay this portion of the debt, Ben will never be personally liable for its repayment.

Initial basis	$80,000
Less nonrecourse debt	(30,000)
Basis for at-risk purposes	$50,000

Note: Ben's $40,000 personal loan to the LLC is considered at risk because he personally advanced these funds to the LLC. And, because $50,000 of Ben's initial basis of $80,000 is still considered at risk, all of the $50,000 K-1 loss is deductible after applying Step 2.

Question 35C. Step 3. How do the **passive loss** rules limit the deduction of this $50,000 loss on Ben's Schedule E, page 2 if he has no other sources of passive income?

Answer 35C. Since Ben does not have any passive income, none of the $50,000 loss can be deducted on Schedule E, page 2. Instead, this $50,000 is suspended and listed on the Form 8582 worksheet.

Example 36. Keeping Track of Suspended Losses. Use the same facts as **Example 35**, except Ben's share of the entity's loss for the tax year is $100,000.

Question 36A. What is Ben's **basis** assuming no distributions were made during the year?

Answer 36A. Ben's basis is $80,000 under Step 1 (the same as in **Example 35**). Therefore, $20,000 (of the total $80,000 K-1 loss) is suspended due to the lack of basis.

Cash contribution	$ 10,000
Personal loan to LLC	40,000
Share of nonrecourse debt (allocated based on §752(a))	30,000
Initial basis from Example 35	$ 80,000
Less K-1 loss	(100,000)
Suspended loss due to lack of basis	($ 20,000)

Question 36B. What part of this basis is considered **at risk?**

Answer 36B. Ben's at-risk basis in Step 2 is again $50,000. Therefore, $30,000 of the total $80,000 loss allowed in Step 1 is suspended as follows:

Step 1 loss allowed	$80,000
Step 2 at-risk basis	(50,000)
Suspended loss due to lack of basis	$30,000

Question 36C. How do the **passive loss** rules limit the deduction of this $100,000 loss on Ben's Schedule E, page 2 if he has $30,000 of passive income from other sources?

Answer 36C. Since Ben has $30,000 of passive income, $30,000 of the total $50,000 loss from Step 2 is allowed and listed on Schedule E, page 2. The remaining $20,000 loss suspended due to the lack of passive income is listed on the Form 8582 worksheet.

At-risk loss allowed	$50,000
Step 3 passive loss limitation	(30,000)
Step 3 suspended passive loss	$20,000

Example 37. Taking Suspended Losses in Subsequent Tax Year. Use the same facts as **Example 36.** The LLC is successful in the second year of its operations and reports an allocable share of trade or business income on Ben's Schedule K-1 of $50,000. Ben continues to hold this interest strictly as an investment and does not materially participate in the LLC business. He has no other sources of passive income and there was no change in the LLC debt.

Question 37A. What is the effect of this LLC income on Ben's **basis?**

Answer 37A. The three steps are applied as follows:

Step 1: Ben's basis of zero from Year 1 is now increased to $50,000.

Step 2: Since this source of basis was from Ben's share of LLC income, and not from his share of LLC debt, (under §752(a)) it need not be tested for purposes of the at-risk rules.

Note. Sometimes this type of basis is referred to as **hard basis.** The same is true of basis derived from capital contributions of either cash or property. On the other hand, basis derived from a share of LLC debt is referred to as **soft basis** and must always be tested under the at-risk rules.

Step 3: This $50,000 of LLC K-1 income is considered passive income.

Question 37B. Are any of the **suspended losses** available to report on Ben's Schedule E, page 2 in this second tax year?

Answer 37B.

Answer 37B. Yes, Ben is now able to deduct $50,000 of suspended passive losses from Year 1, computed as follows:

Step 1: Since Ben now has $50,000 of basis in his LLC interest, the $20,000 of suspended loss from Year 1 (due to lack of basis) is allowed as follows:

Basis at beginning of Year 2	$ 0
Share of Year 2 LLC income	50,000
Basis at end of Year 2	$50,000
Year 1 loss suspended due to lack of basis	(20,000)
Final basis at end of Year 2	$30,000

Step 2: Since the $50,000 basis increase is due to Ben's allocable share of LLC income (and not due to a change in his share of LLC debt), all is considered at risk. Therefore, Ben's at-risk basis of zero at the beginning of Year 2 increases $50,000. This results in all of the suspended loss of $50,000 from Year 1 being allowed as follows:

At-risk basis at beginning of Year 2	$ 0
Increase to at-risk basis due to Ben's share of Year 2 LLC income	50,000
At-risk basis at end of Year 2	$50,000
Year 1 loss suspended due to zero at-risk basis	(50,000)
Final at-risk basis at end of Year 2	$ 0

Step 3: Since Ben's share of LLC income is considered passive, this $50,000 frees up $50,000 of the total $70,000 loss suspended from Year 1 and is shown on the Form 8582 passive loss worksheets, as follows:

Suspended loss at end of Year 1 (on Form 8582)	$70,000
LLC income from Year 2	(50,000)
Passive loss still suspended at end of Year 2	$20,000

To summarize, since Ben received an allocable share of LLC income in Year 2 equal to $50,000, he is now able to take $50,000 of the $70,000 loss suspended from Year 1. He shows this as a separate item on Schedule E, page 3, line 28. Also, Ben must check "yes" for the box on line 27 since he is taking a loss suspended from a prior tax year. The suspended $20,000 loss continues to be shown on the Form 8582 passive loss worksheets and is carried over to Year 3.

Example 38. Effect of Distribution on Basis in Break Even Year. Use the same facts as **Example 36**, with Ben's basis being zero at the end of the tax year. He receives a $25,000 distribution during the subsequent tax year.

Question 38A. Would the distribution be taxable if the LLC broke even?

Answer 38A. Even though none of the original $100,000 K-1 loss was allowed after applying the three steps, Ben's basis was zero and therefore the entire $25,000 distribution is taxed.

Question 38B. How does the answer change if the LLC is profitable for the subsequent tax year and Ben's K-1 share is $10,000?

Answer 38B. Ben's zero basis from the first tax year increases to $10,000.

As a result, only $15,000 of the total $25,000, distribution is taxed as follows:

Basis at end of Year 1	$ 0
K-1 profit for Year 2	10,000
Available basis for distribution	$10,000
Less distribution	(25,000)
Excess distribution (taxable in Year 2)	($15,000)

Note: Even through Ben received no tax benefit from the $100,000 K-1 loss in Year 1 (because the passive loss rules limited any of the loss from being deducted), his basis is still zero. It is the basis in ownership interest that is used to measure possible taxation of a distribution made during the tax year.

Example 39. Effect of Distributions on Basis in Profitable Years. Use the same facts as **Example 36** with Ben's basis being zero at the end of the year. However, he receives a $25,000 distribution during the subsequent year.

Question 39. How would the distribution be taxed if Ben's share of the LLC profit in Year 2 was $50,000?

Answer 39. Although Ben technically has a zero basis in March of Year 2 when he extracts the cash, he can "anticipate" the restoration of sufficient basis by the end of the tax year to cover this amount. This is due to his share of the anticipated LLC profit.

Therefore, his basis goes from zero to $50,000, and is then reduced by the $25,000 distribution taken earlier in the year.

Basis at end of Year 1	$ 0
K-1 profit for Year 2	50,000
Available basis for distribution	$50,000
Distribution	(25,000)
Basis at end of Year 2	$25,000
Taxable portion of distribution in Year 2	$ 0

The remaining $25,000 of basis is available to utilize suspended losses carried over from Year 1.

Example 40. Distributions Not Limited to At-Risk Basis. Larry's basis is zero at the beginning of the tax year. During March, he takes a $50,000 cash distribution. At the end of that tax year, Larry's distributive share of partnership income is $25,000. The partnership also has a nonrecourse liability on its books (other than "qualified real property indebtedness") for which Larry is allocated $30,000 as an increase to his basis.

Question 40. Will any of the cash distribution made earlier in the year be taxable to Larry?

Answer 40. Larry's basis is first increased by his distributive share of partnership income for the tax year, in addition to his share of debt as permitted under §752(a). Therefore, Larry's basis goes from zero to $55,000 as of December 31. This is the level of basis used to determine if sufficient basis exists to cover the amount distributed earlier in the year.

With $55,000 of basis, there is enough to cover the partnership's $50,000 cash distribution to Larry. It is important to note that the test for possible taxation is **not** based upon the partner's at-risk basis (only $25,000). A partner's basis is determined **before** the application of the at-risk rules in making this determination.

Note. The at-risk rules do **not** affect the tax basis of a partner's interest, or the amount of gain or loss realized by him if he should sell his interest. Instead, these **at-risk rules merely serve to limit the amount of K-1 loss that may be deducted by a partner in a particular tax year.**

FAMILY LIMITED PARTNERSHIPS

More and more family limited partnerships (FLP) are being used to secure sizable discounts in order to minimize gift tax on lifetime transfers. They are also used to decrease, to the greatest extent possible, the value of the limited partnership interests that the decedent parent still owns at death, and that will eventually be included in that parent's estate.

In a typical arrangement, an FLP is formed with the parents each receiving a 1% general partnership interest and a 49% limited interest. With the general partnership interests, the parents are assured continual control over the partnership's activities regardless of how low their limited partnership interests might go. Because of significant restrictions on the ability of the limited partners to either dispose of their interests to outside third parties, or to control the partnership activities, these interests are severely discounted for transfer tax purposes. The recipients of the limited interests are normally the children and grandchildren who are gifted the limited interests over a period of time. Even when the FLP holds only publicly traded securities, it is not uncommon for discounts of up to 30% to be used in valuing the limited partnership interests transferred to the younger generations. For FLPs also holding trade or business assets, some taxpayers are seeking discounts approaching 40% or more.

ENDING THE FLP AND DISTRIBUTING ASSETS

When parents in an FLP die, the heirs (children) may want to end the FLP and distribute the assets. It is important to consider the implications of §704(c) related to the 7-year period prior to distributing assets.

If property is contributed to a partnership and, **within seven years,** distributed to "any other partner," the precontribution gain originally inherent in the property is **taxed to the successor partner.**[103] According to the Committee Reports for §704(c), this includes **any** successor partner.

Are the children who inherit the FLP interests as part of their parents' estate considered "successor partners" for this purpose?

If the children are considered "successor partners," then they must assume this inherent gain. It is possible that the partnership interests might have received at least some step-up to their FMV as of the date of the parent's death.

It is expected that the executor preparing the Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, will be as aggressive as possible in valuing (discounting) the general and limited partnership interests that either one of the parents held at the time of death. Yet the value might be at FMV above the basis that the parent held in such interest at death. To the extent that there is a step-up, the children inheriting these interests should be allowed to make a §754 election to take a corresponding step-up to the inside bases of the assets that the FLP still holds.

The step-up to the bases of the partnership's inside assets eliminate at least some of the §704(c) gain.

> **Note.** To the extent that some precontribution gain still exists in the FLP assets, practitioners typically caution children inheriting FLP interests to hold the assets for the remainder of the 7-year period. This renders the issue moot should they eventually decide to distribute the assets originally contributed to the partnership.

103. IRC §704(c)(1); however the contributing partner (i.e., the parent) is now dead, so there is no taxpayer to attribute this gain back to other than the children who step into their parent's shoes as successor partners.

OPTIONAL STEP UP IN BASIS UNDER §754

IRC §754 was implemented to prevent the double taxation of gain on partnership assets. This can occur when:

- Existing partners purchase the interest of an exiting (retiring) partner, or
- The entity distributes property in complete termination of a partner's ownership interest.

When a new partner becomes an **owner of the entity through an inheritance,** the following issues should be considered.

1. **Outside Cost versus Inside Basis.** The outside basis of the partnership interest (FMV at the date of death) inherited by the new partner can be substantially greater than the inside bases of the various assets on the partnership's books. If any of these assets are disposed of in a taxable transaction, this new partner must pay tax on his distributive share of the gain.
2. **Accounts Receivable.** In service-type partnerships (professional firms) using a cash basis, the mere collection of accounts receivable results in a proportionate share of the underlying gain flowing to the new partner. This is the case even though they have an outside basis equal to the FMV of outstanding receivables.
3. **Depreciable Assets.** With depreciable assets, the new partner receives his proportional share of any current depreciation based on the adjusted basis of the particular asset at the time of his entry into the partnership. However, without a special election under §754, there is no additional depreciation based on the asset's current FMV flowing to this new partner.
4. **Amortizable Goodwill.** Another issue with service-type partnerships is that there might not be any amortizable goodwill unless the business was acquired by purchase since August 10, 1993. However, the date-of-death value of the partnership interest includes the FMV of existing goodwill. The new partner will receive the benefit of the goodwill. With a §754 election, at least his proportional share of the firm's goodwill is amortized under §197 with this deduction being specially passed through on his Schedule K-1. The amount is amortized over 180 months.

Background

Normally, the basis of partnership property is **not adjusted** as the result of a **distribution of property** to a partner unless the partnership has an election in effect under §754.[104] In addition, the basis of partnership property is **not adjusted** as the result of a **transfer of an interest** in a partnership unless the partnership has an election in effect under §754.[105]

However, §754 provides that if a partnership files an election in accordance with regulations prescribed by the Secretary, the basis of partnership property is adjusted. In the case of a **distribution of property,** the basis is adjusted in the manner provided in **§734(b).** In a **transfer of a partnership interest,** the basis is adjusted in the manner provided in **§743(b).**

Distribution of Property. IRC §734(b) provides that in the case of a distribution of property to a partner, a partnership that has a §754 election in effect increases or decreases the partnership property's adjusted basis under specified circumstances. The amount of increase is the amount of gain recognized to the distributee partner for the distribution.[106]

Basis of Property. IRC §732(a)(1) provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is generally equal to the property's adjusted basis to the partnership immediately before the distribution. The property's basis to the distributee partner is limited to the adjusted basis of the partner's interest in the partnership, reduced by money distributed in the same transaction.[107]

104. IRC §734(a)
105. Ibid
106. IRC §734(b)(1)(A)
107. IRC §732(a)(2)

Allocation of Basis Adjustments. The allocation of any basis adjustment among partnership properties is made in accordance with IRC §755.[108] In the case of a transfer of an interest in a partnership by sale or exchange, or upon the partner's death, a partnership that has a §754 election in effect increases or decreases the partnership property's adjusted basis under specific circumstances.[109] The allocation of any basis adjustment among partnership properties is in accordance with §755.[110]

The basis adjustment is allocated among partnership properties in a manner that reduces the difference between the FMV and the adjusted tax bases of those properties.[111] In applying the §755(a) allocation rules, increases or decreases in the partnership property's adjusted tax basis arising from a distribution or transfer of an interest attributable to capital assets and property described in §1231(b) (capital assets), or any other property of the partnership are allocated to partnership property of "like character."[112]

When an adjustment to the basis of undistributed partnership property under §734(b)(1)(B) occurs, the adjustment is allocated to the remaining partnership property of a character "similar to that of the distributed property."[113]

If there is an increase in basis to be allocated to partnership assets, the increase must be allocated only to assets whose values **exceed** their bases and in proportion to the difference between the value and basis of each.[114] However, no increase may be made to the basis of any asset which has an adjusted tax basis **equal to or exceeding** its FMV.

Making the §754 Election

IRC §754 provides the manner in which a partnership files an election to adjust the basis of partnership property under §743.

An election made under §754 applies to all property distributions and transfers of partnership interests taking place in the partnership taxable year for which the election is made and in all subsequent years unless revoked under Treas. Reg. §1.754-1(c).[115]

The election is made in a written statement filed with the partnership return for the taxable year during which the distribution or transfer occurs.[116] For the election to be valid, the return must be timely filed (including extensions).[117] Once the election is made, it is effective for all distributions of property to a partner and to all transfers of interests in the partnership occurring in the year of sale and subsequent years, unless revoked.[118]

Caution. Even though this discussion involves two separate basis adjustment provisions,[119] there is only **one election provision.** It is contained in §754. This provision applies to both §734(b) and to §743(b). As a result, a partnership must elect to have the basis adjustment provision **applied to both or neither.**[120] In addition, there is no provision for revoking a §754 election. Without the consent of the IRS, the election is permanent and lasts until the partnership dissolves.[121]

108. IRC §734(c)
109. IRC §743(b)
110. IRC §743(c)
111. IRC §755(a)(1)
112. IRC §755(b)
113. Treas. Reg. §1.755-1(b)(1)
114. Treas. Reg. §1.755-1(a)(1)(ii)
115. Treas. Reg. §1.754-1(a)
116. Treas. Reg. §1.754-1(b)(1)
117. If the §754 election is filed late, some relief may be available under Treas. Reg. §301.9100-2.
118. Treas. Reg. §1.754-1(c)
119. IRC §§734(b) and 743(b)
120. Treas. Reg. §1.754-1(a)
121. Treas. Reg. §1.754-1(c)

Additional Issues Regarding the §754 Election

Although the basis adjustment provisions outlined in §§734(b) and 743(b) work in a similar fashion, an important distinction exists.

- The inside basis adjustment contained in §734(b) applies to **all partners equally.**
- The inside basis adjustment contained in §743(b) only affects the **purchasing partner.**

It is important to realize that if a partnership has a §754 election in effect, distributions made by the entity to its partners will **not** upset the equality between aggregate inside and aggregate outside bases. No distribution which the partnership makes affects the relationship between aggregate inside and aggregate outside bases. Therefore, if this aggregate sum is equal prior to a distribution or disposition, it remains so afterward. If it is unequal before, this inequality continues to the same extent after the event.

Adjustments Made Pursuant to §743(b)

If the partnership has a valid §754 election, §743(b) requires the partnership to adjust the basis of the partnership property after a transfer of a partnership interest by sale or exchange occurs, or upon the death of a partner. The adjustment to the partnership property's basis controlled by the provisions of §743(b) is only going to affect the new partner. The new partner is either a partner who just purchased a partnership interest, or the successor partner who just inherited a partnership interest as a result of a former partner's death.

The amount of the adjustment equals the difference between the transferee's outside basis and the transferee's inside basis. The outside basis is either:

- The purchase price paid for the partnership interest in a sale or exchange, or
- The FMV of the partnership interest which was inherited by the successor partner.

The inside basis is the new partner's share of the partnership's bases in its assets.[122]

It is also possible that the adjusted bases of partnership property must be decreased. It would be decreased by the excess of the transferee's share of the adjusted bases to the partnership of the partnership's property less the transferee's basis for the transferred, newly purchased, or inherited partnership interest. [123]

As a result of this adjustment, only the new partner has a special inside basis on her share of the partnership's assets. This is used for purposes of determining such tax items as income, deduction, loss, and gain on the disposition of any of these assets. For example, for depreciation deductions, the new partner receives her normal share in a pro rata fashion depending on the partnership agreement.[124] However, her Schedule K-1 contains additional information which lists an additional amount of depreciation due to this incremental step-up in the underlying basis of the particular asset. This flows solely to this new partner.[125]

Caution. For transfers made on or after December 15, 1999, the regulations make it clear that it is the responsibility of the partnership to make the basis adjustments required by §743(b). It also shifts the responsibility for reporting the basis adjustments to the entity.[126] To accomplish this, the regulations require that the partnership actually attach a statement to the partnership return which lists the specific partnership items affected by the basis adjustments, so that amounts reported on the transferee's Schedule K-1 reflect the adjusted amounts.[127]

122. Treas. Reg. §1.743-1(b)(1)
123. Treas. Reg. §1.743-1(b)(2)
124. Treas. Reg. §1.743-1(d)(1)
125. Treas. Reg. §1.743-1(j)(2)
126. Treas. Reg. §1.743-1(k)(1)
127. Treas. Reg. §1.743-1(k)(1)(i)

It is the responsibility of the transferee partner to notify the partnership of the transfer of the partnership interest that is affected by the §743(b) adjustment. When the transfer is due to a sale or exchange of a partnership interest, the notification, along with the information specified in the regulations must be made within 30 days of the transfer.[128] If the transfer results from the death of a partner, the notification (along with the information specified in the regulations), must be made within one year of the date of death.[129]

Observation. When making the §743(b) basis adjustments, the partnership is allowed to rely on information provided in the notification supplied by the transferee partner, unless the tax matters partner "has knowledge that the information is not accurate."[130] Even though the partnership is not technically required to make the §743(b) adjustments until it has received notice from the transferee partner, it is deemed to have notice not only when it receives actual notification from the transferee partner, but also if the tax matters partner has actual knowledge of the transfer.[131]

Allocation of Basis Adjustments Controlled by §755

Even though §§734(b) and 743(b) dictate the amount of optional and mandatory basis adjustments, §755 provides the rules which control the actual allocation of those amounts to specific partnership assets.

Generally, a **basis adjustment can only be made to assets when the effect of the adjustment closes the gap between the property's adjusted tax basis and its book value.** Positive adjustments can only be made to appreciated property, and negative adjustments can only be made to property whose value is below its adjusted tax basis.[132]

Adjustments made to particular assets are not allowed to exceed the unrealized appreciation or loss inherent in that asset. For those assets which have an adjusted tax basis equal to their book value, no optional or mandatory basis adjustment is permitted.[133]

The allocation process follows these steps.

1. The partnership ascertains each asset's book value.
2. The assets are divided into **two distinct classes of property,** with the basis adjustment being allocated between the two groups. These two property classes are made up of the partnership's capital assets, which include §1231 assets ("capital gain" property) and all the other assets of the entity ("ordinary income" property). The latter group includes any unrealized receivables such as cash basis receivables and depreciation recapture.
3. An appropriate part of the overall basis adjustment is allocated to one of these two classes.
4. Further allocation to the particular assets within that class is accomplished as needed to close the gap between that asset's adjusted tax basis and its book value.

Observation. A special rule applies to transfers of partnership interests and distributions of partnership property that occur on or after June 9, 2003. If the partnership's assets constitute a trade or business, the entity is required to initially determine the assets' values exclusive of any **§197 intangibles.** The partnership calculates the overall value of all of its assets. Usually, the residual method found under §338 is used to assign this incremental excess to these intangible assets.

128. Treas. Reg. §1.743-1(k)(2)(i)
129. Treas. Reg. §1.743-1(k)(2)(ii)
130. Treas. Reg. §1.743-1(k)(3)
131. Treas. Reg. §1.743-1(k)(4)
132. IRC §755(a)
133. IRC §755(b)

Example 41. Allocation of Code §743(b) Adjustment Under §755 Allocation Rules Between Classes of Property. Zach and Tricia form a partnership in which they are equal partners. Zach contributes $50,000 plus Asset 1. Asset 1 is a nondepreciable capital asset with a book value of $50,000 and an adjusted basis of $25,000. Tricia contributes $100,000 which the partnership uses to purchase Assets 2, 3, and 4.

After a year, Zach sells his interest in the partnership to Stu for $120,000. At the time of the transfer, Zach's share of the partnership's tax basis in partnership assets is $75,000 ($50,000 + $25,000). As a result, Stu receives a $45,000 ($120,000 – $75,000) basis adjustment. Immediately after the transfer of the partnership interest to Stu, the adjusted basis and FMV of partnership's assets are as follows:

Assets	Adjusted Basis	FMV	Built-In Gain	Appreciation
Capital gain property:				
Asset 1	$ 25,000	$ 75,000	$25,000	$25,000
Asset 2	100,000*	117,500	0	17,500
			$25,000	$42,500
Ordinary income property:				
Asset 3	$ 40,000	$ 45,000	$ 0	$ 5,000
Asset 4	10,000	2,500	0	(7,500)
Total:	$175,000	$240,000	0	($ 2,500)

*$50,000 from Zach and $50,000 from Tricia

If the partnership sold all of its assets in a fully taxable transaction at FMV immediately after the transfer of the partnership interest to Stu, the total amount of capital gain that would be allocated to Stu would be $46,250 ($25,000 of **§704(c)** built-in gain from Asset 1, plus 50% of the $42,500 appreciation in capital gain property).

Also, Stu would also be allocated a $1,250 (50% of $2,500) ordinary loss from the sale of the ordinary income property. As a result of this hypothetical calculation, the basis adjustment allocated to ordinary income property is equal to ($1,250) (i.e., the loss allocated to Stu from the hypothetical sale of the ordinary income property). Also, the basis adjustment allocated to capital gain property is equal to $46,250 (i.e., $45,000 of basis adjustment, minus $1,250 loss allocated to Stu from the hypothetical sale of the ordinary income property).

Allocation of Basis Adjustment Within a Class of Property

Once the §743(b) allocation is made between the two classes as previously discussed, the adjustment amount is allocated among the assets within each class.[134] Since negative basis adjustments are allowed for some items, it is possible for an adjustment allocated to one asset within a class to be positive, while an adjustment allocated to another asset within that same class to be negative.[135]

Example 42. Allocation of §743(b) Adjustment Under §755 Allocation Rules within a Particular Class of Property. Use the same facts as **Example 41.** The $45,000 basis adjustment consisted of $46,250, allocated to capital gain property, and ($1,250), allocated to ordinary income property. The allocation of $46,250 within the **capital gain property** class is further allocated as follows:

- Stu would be allocated **$37,500** from the sale of Asset 1 in the hypothetical transaction. This is the $25,000 of built-in gain plus 50% of the appreciation. As a result, the adjustment to Asset 1 is $37,500.
- Stu would be allocated **$8,750** (50% × $17,500) from the sale of Asset 2 in the hypothetical transaction. Thus, the adjustment to Asset 2 is $8,750.

The allocation of the ($1,250) within the **ordinary income property** class would be further allocated as follows:

- Stu would be allocated **$2,500** (50% × $5,000) from the sale of Asset 3 in the hypothetical transaction. Therefore, the adjustment to Asset 3 is $2,500.
- Stu would be allocated **($3,750)** [50% × ($7,500)] from the sale of Asset 4 in the hypothetical transaction. Therefore, the adjustment to Asset 4 is ($3,750).

134. Treas. Reg. §1.755-1(b)(3)

135. Treas. Reg. §1.755-1(b)(1)(i)

Basis Adjustment Not Allocated to IRD Items Held by Partnership

When a partnership interest is transferred as a result of a partner's death,[136] the transferee's basis is **not** adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent (IRD) under §691. Therefore, if a partnership interest is transferred as a result of a partner's death, and the partnership holds assets representing IRD, no part of the basis adjustment under §743(b) is allocated to these assets.

Example 43. Basis Adjustment Not Allocated to IRD Items Held by Partnership. Harvey and Lisa are equal partners in an accounting services partnership. In 2006, as a result of Lisa's death, Lisa's partnership interest is transferred to Milton. At that time, the partnership's balance sheet (which uses the cash method) is as follows:

	Adjusted Tax Basis	FMV
Assets		
Goodwill	$2,000	$ 5,000
Accounts receivable	0	15,000
Total	$2,000	$20,000
Liabilities and equity		
Capital: Harvey	$1,000	$10,000
Capital: Lisa	1,000	10,000
Total	$2,000	$20,000

None of the assets owned by the partnership are §704(c) property,[137] and the goodwill is not amortizable (not purchased after August 10, 1993). The FMV of Milton's partnership interest on the applicable date of valuation[138] (date of Lisa's death) is $10,000. Of this amount, $2,500 is attributable to Milton's 50% share of the partnership's goodwill and $7,500 is attributable to Milton's 50% share of the partnership's unrealized receivables.

The partnership's unrealized receivables represent IRD. As a result, Milton's basis in his partnership interest is **not** adjusted for that portion of the interest which is attributable to the unrealized receivables.[139] Therefore, Milton's inside basis in his partnership interest is only allowed to be stepped up to $2,500 (and not the full $10,000 date-of-death value).

Observation. Milton's outside basis for his inherited partnership interest is still $10,000. If he receives a distribution, sells it in a taxable transaction, or otherwise has a loss flow through on his Schedule K-1, this becomes the initial basis used for making any tax determination.

136. IRC §1014(c)

137. Contributed property with precontribution gain

138. IRC §1014

139. IRC §1014(c)

§732(d) BASIS ADJUSTMENT EQUIVALENT FOR DISTRIBUTED PROPERTY

When the partnership does **not** have a §754 election in effect, the distribution of the partnership's property can still result in the equivalent of a §743(b) basis adjustment in certain instances.

If a partner acquires his partnership interest by either purchase, taxable exchange, or devise and no §754 election is currently in effect, the partner is permitted to elect to have the equivalent of a §743(b) basis adjustment applied to any property distributed by the partnership to him **within two years** of the original acquisition date of his partnership interest.[140]

Note. Because this election can be made on a distribution-by-distribution basis, the transferee partner can effectively elect to adjust basis for a particular distribution in one year, and then choose to forgo the election for another distribution from the same partnership in the second year.

Making the §732(d) Election

The election is made by attaching a statement to the individual partner's tax return. It should contain a detailed computation of the amount of the adjustment, and list the properties to which it is allocated.[141] The regulations state that if the distribution involves property subject to an allowance for depreciation, depletion, or amortization, the election must be made by the due date, including extensions, of the partner's tax return for the tax year of the distribution. If such property is not the subject of the distribution, the election must be filed "for the first tax year in which the basis of the distributed property is relevant to the determination of the partner's taxable income."[142]

Observation. Effectively, this is a substitute of the distributee's outside basis for such property and what was the partnership's inside basis for the distributed property.

There are **three** requirements which must be met in order to make the §732(d) election:

1. No §754 election was in effect when the distributee partner first acquired his interest in the partnership.
2. The property, which is the subject of the election, was distributed within two years of the acquisition of the partnership interest.
3. The distributee partner files the election within the appropriate time limits.

IRC §732(d) Election Treated as Mandatory in Some Instances

In some cases, even when the distribution occurs **more than two years** after the distributee partner first acquired his partnership interest, this basis adjustment is mandatory.

The §732(d) adjustment **must be made** when:

1. The distributee partner acquired his partnership interest by purchase, taxable exchange, or devise at a point in time when a §754 election was not in effect.
2. The distributee partner acquired his partnership interest, and the FMV of all partnership property (excluding money) exceeded 110% of the partnership's adjusted bases in its property.

---

140. IRC §732(d)

141. Treas. Reg. §1.732-1(d)(3)

142. Treas. Reg. §1.732-1(d)(2)

3. The distributee partner's interest in the partnership is liquidated immediately after the acquisition of his partnership interest, and the effect of the basis allocation rules in §732(c) shifts basis from nondepreciable property to depreciable property.

4. A §743(b) basis adjustment results in a change to the basis of the transferee partner related to the property actually distributed.[143]

Observation. The net effect of this mandatory §732(c) basis adjustment rule is to prevent a distribution of property from causing a transference of basis from capital assets (which are sometimes referred to as "cold assets") over to the basis of ordinary income assets (which are sometimes referred to as "hot assets"). Additionally, even though depreciable, amortizable or depletable assets might not be "hot assets," an increase in their bases results in yearly additional deductions which have the net effect of offsetting other ordinary income of the partnership.[144]

Example 44. Mandatory §732(d) Basis Adjustment. Alfa-Bet partnership has a balance sheet listing cash of $20,000 and raw land with an adjusted tax basis of $100,000 and a $200,000 FMV. Four individuals are equal partners in Alfa-Bet. One of the partners, Dick, decides to sell his partnership interest to partner Ed, for its current FMV of $55,000 [($20,000 + $100,000) ÷ 4]. Currently, the partnership does not have an election under §754. Dick's outside basis and capital account are both $30,000.

Because the partnership does not have a §754 election in effect when Ed purchases Dick's partnership interest, this purchase has no impact on the partnership's inside basis of the land.[145] If, within the following two years, the partnership distributes a 25% interest in the property to Ed in a nonliquidating distribution, Ed recognizes no gain or loss on the distribution. Without a §732(d) basis adjustment, Ed simply takes a carryover basis in the distributed property of $25,000.[146] Ed's outside basis in his partnership interest decreases from $55,000 to $30,000.[147]

If Ed elects to apply an optional §732(d) basis adjustment, the basis of the distributed property is recomputed as if it were subject to §743(b). The interest in the property distributed to Ed receives a step-up in basis equal to $50,000.[148] The outside basis in his partnership interest is correspondingly reduced to $5,000 (his share of the cash that the partnership holds).[149] The effect of the §732(d) adjustment is to shift an additional $25,000 of Ed's outside basis to the distributed property. This is the same net effect as if a §754 election was in place when Ed originally purchased his partnership interest from Dick.

Observation. Once the partnership is notified by the distributee partner that he plans to make a §732(d) basis adjustment election, the entity must provide this partner with the necessary information so he can compute the basis adjustment. He must include this with the election statement that he files with his individual tax return.[150] The same is true if such a basis adjustment is otherwise mandatory.

143. Treas. Reg. §1.732-1(d)(4)
144. *Rudd v. Commr.,* 79 TC 225 (1982), August 9, 1982
145. IRC §743(a)
146. IRC §732(a)(1)
147. IRC §733(2)
148. IRC §732(a)(1)
149. IRC §733(1)
150. Treas. Reg. §1.732-1(d)(5)

Required Adjustments To Prevent Duplication Of Built-In Loss

The American Jobs Creation Act of 2004 requires that a partnership make certain inside basis adjustments in order to prevent duplication of a substantial built-in loss.[151] This rule applies even if the partnership does not have a §754 election in effect.

A substantial built-in loss is one in which there is an asset with basis in excess of $250,000 over its FMV at the time of a triggering event. The special basis adjustments apply to the following circumstances:

1. A partner contributes property with a substantial built-in loss to the partnership. Later, the contributing partner's interest is sold or redeemed.[152]
2. A partner recognizes a substantial built-in loss on a sale of his or her interest in the partnership. The partnership has property which would result in a substantial built-in loss if sold, and the new partner's inside basis exceeds his or her outside basis by more than $250,000.[153]
3. A partner recognizes a substantial built-in loss on a distribution, or steps up the basis of distributed property, and the total of the loss and the step up exceeds $250,000.[154]

5

Observation. There are several exceptions to the new rules. Some relate to transitional phase-ins and others relate to special types of partnerships. Investment company partnerships may elect to not have the new rules apply, and the new rules do not apply to securitization partnerships.

IRC § 751 "HOT ASSETS"

The purpose of §751 is to ensure each partner reports her share of the partnership's ordinary income. For example, when a partner sells her interest in the partnership, §741 treats this as a sale of a capital asset resulting in either capital gain or loss to the partner. In actuality, the partner is literally selling her indirect ownership percentage in each of the assets that the partnership holds. Instead of using the 15% capital gains rate on any recognized gain, the partner must recharacterize this gain as being subject to other possible income tax rates. These are 25% for unrecaptured §1250 gain, 28% for collectibles, or up to 35% for ordinary income assets such as unrealized receivables, appreciated inventory, or depreciation recapture.

Even distributions that rearrange the partners' indirect interests in certain ordinary income assets (unrealized receivables and appreciated inventory items) are taxed as a sale or exchange between the distributee partner and the partnership.[155] Consequently, either the partner or the partnership may recognize gain or loss on the recharacterized transaction.

The §751 hot asset rules can come into play with **both** nonliquidating and liquidating distributions. However, this is true only to the extent that a partner receives:

- Hot assets in exchange for any part of his interest in other property,
- Other property, or
- Non-hot assets in exchange for any part of his interest in hot assets.[156]

---

151. AJCA §833
152. IRC §704(c)(1)(C)
153. IRC §743(b)
154. IRC §§734(b), 734(d)
155. IRC §751(b)
156. Treas. Reg. §1.751-1(b)(1)(i)

When §751 Rules Do Not Apply

IRC §751(b) does **not** apply to the following:

- Distributions of property that the distributee partner originally contributed to the partnership;[157]
- Payments to a retiring partner, or a deceased partner's successor interest made under §736(a);[158]
- Draws or advances against a partner's distributive share;[159]
- Distributions treated as gifts;[160]
- Payments for services;[161] and
- Payments for the use of capital.[162]

Unrealized Receivables

Unrealized receivables are **not exclusively** limited to cash basis receivables in a service-type partnership. Treas. Reg. §1.751-1(c)(1) distinguishes when an agreement confers a property right, and not just a right to payment for goods or services. Such an agreement is not an "unrealized receivable."[163] The term also extends to the rights to a payment that results from a contract or agreement that is in existence at the time a partnership interest is sold, or a distribution of partnership property is made.

This situation might arise in an accrual basis partnership in which all of their receivables are "realized" and, therefore, have an adjusted basis which approximates their current FMV. However, the entity can still have unaccrued contract rights for services to be performed and goods to be delivered in the future which fall under the definition of an "unrealized receivable." Any depreciation recapture[164] is also included.

Substantially Appreciated Inventory

Substantially appreciated inventory includes any partnership assets held for sale to customers in the normal course of its trade or business. It also includes all partnership property that, if sold or exchanged, is considered a noncapital asset, or property **not** used in the partnership's trade or business.[165]

In order to be "substantially appreciated," the total FMV of all the partnership's inventory items must exceed 120% of the aggregate adjusted bases for those items.[166] A key point to understand in this test is that "unrealized receivables" as well as "realized receivables" (most likely in an accrual basis partnership) are included in the definition of "inventory" when ascertaining whether the 120% mark was passed.

---

157. IRC §751(b)(2)(A)
158. IRC §751(b)(2)(B)
159. Treas. Reg. §1.751-1(b)(1)(ii)
160. Treas. Reg. §1.751-1(b)(1)(ii)
161. Treas. Reg. §1.751-1(b)(1)(ii)
162. Treas. Reg. §1.751-1(b)(1)(ii)
163. Ltr. Rul. 9845012, August 6, 1998
164. Generally IRC §§1245 or 1250, but also includes several other ordinary income items under §§1252, 1253, and 1254
165. Treas. Reg. §1.751-1(d)(2)
166. Treas. Reg. §1.751-1(d)(1)

Observation. Making the determination as to whether a partnership's inventory assets are substantially appreciated requires an examination of the inventory as a whole. If the total of the inventory assets surpasses the 120% point, then every item of inventory is treated as being substantially appreciated. However, if the inventory assets taken as a whole do not meet this test, then no item of inventory is considered to be substantially appreciated.

Example 45. Substantially Appreciated Inventory. Consider the following balance sheet of ABC Partnership:

Asset	Adjusted Tax Basis	FMV
Cash	$50,000	$50,000
Receivables	0	80,000
Inventory	10,000	20,000
Land	30,000	50,000

The total FMV of all inventory items, which includes receivables, is $100,000 ($80,000 + $20,000) and the adjusted basis of all inventory items is $10,000. Because the total FMV of all inventory items ($100,000) is more than 120% of the adjusted basis of all inventory items ($10,000), the partnership's inventory is considered substantially appreciated. As a result, both ABC's inventory and receivables are treated as §751(b) property (hot assets).

Note. If an accrual basis partnership has significant realized receivables, it is less likely that the substantially appreciated test will be met because receivables are included in the aggregate adjusted bases for all inventory items.

Operation of §751 Hot Asset Rules

IRC §751(b) applies when a non pro rata distribution of a partnership's hot assets is made to a partner which has the effect of "rearranging" the partners' shares of §751(b) property. In making this determination, the distributee partners' predistribution interest in hot assets versus non-hot assets is compared with their respective postdistribution interests in such property. If such a shift in the partners' interests in the partnership's hot assets occurs, then the distribution is treated as a sale or exchange of property under §751(b).

In order to determine a partner's predistribution interest in each class of property, the partner's percentage interest is multiplied by the amount of property owned by the partnership. Likewise, the partner's postdistribution interest in each class of property is determined by adding the partner's continuing share of the partnership's property to the property that was actually distributed to that partner.[167]

167. Treas. Reg. §1.751-1(b)(1)(ii)

Example 46. Determining Whether a Disproportionate Distribution of Hot Assets Was Made. ABCD Partnership is equally owned by Ace, Bart, Candy, and Donna. Ace receives a liquidating distribution of partnership property that has the effect of reducing his interest in the entity from 25% to 0%.

The distribution consists solely of a $50,000 interest in the land, which the partnership is holding as an investment (a capital asset). Prior to the distribution, the partnership balance sheet consists of the following assets:

	Adjusted Tax Basis	FMV
Assets		
Cash	$ 40,000	$ 40,000
Receivables	0	60,000
Land	60,000	100,000
Total	$100,000	$200,000
Liabilities and equity		
Capital: Ace	$ 25,000	$ 50,000
Capital: Bart	25,000	50,000
Capital: Candy	25,000	50,000
Capital: Donna	25,000	50,000
Total	$100,000	$200,000

In order to determine the tax consequences of the distribution, Ace's predistribution and postdistribution share of the assets and liabilities must be determined.

Step 1: Properties Exchanged.

	§751(b)	Non-§751(b)	
	Receivables	Cash	Land
Ace's postdistribution share	$ 0	$ 0	$50,000
Ace's predistribution share	(15,000)	(10,000)	(25,000)
Properties exchanged	($15,000)	($10,000)	$25,000

The applicability of §751(b) is determined.

Asset Sold		Asset Received		Is §751(b) Applicable?
Receivables	$15,000	Land	$50,000	Yes
Cash	10,000			No

IRC §751(b) applies to the extent Ace's non-§751(b) property that was received in the exchange ($50,000) exceeds the receivables ($15,000). Ace is treated as selling his receivables to the partnership for $15,000.

Step 2: Adjusted Tax Basis of Exchanged Properties. Ace's adjusted tax basis in the exchanged properties is determined.

Ace's adjusted basis in partnership interest	$25,000
Adjusted basis to partnership of receivables	0
Adjusted basis to Ace of receivables	0
Partnership's adjusted basis in land	$60,000
Percentage of property distributed treated as exchanged	× 50%
Adjusted basis to partnership in non-§751(b) property	$30,000

Step 3: Ace's Ordinary Income under §751(b). Ace must determine the ordinary gain under §751(b) to report on the deemed sale of the receivables.

Deemed sale of receivables	$15,000
Ace's basis in receivables deemed sold	(0)
Ace's ordinary income	$15,000

Step 4: Ace's Gain or Loss under §751(b). Ace must determine if he has any gain or loss under §751(b). Since he is not selling non-§751(b) property for §751(b) property, he does not recognize gain or loss under §751(b).

Step 5: Ace's Capital Gain or Loss under §731(a). Because Ace did not receive cash in excess of his basis in the partnership interest, he does not recognize gain under §731(a)(1).

Step 6: Partnership's Ordinary Income under §751(b). Since the partnership is not treated as selling §751(b) property for non-§751(b) property, it does not recognize ordinary income under §751(b).

Step 7: Partnership's Gain or Loss under §751(b).

Partnership deemed sale of land	$25,000
Partnership adjusted basis in deemed sale	(15,000)
Partnership deemed gain	$10,000

Step 8: Partnership's Adjusted Basis in Its Properties.

Partnership deemed purchase of receivables	$15,000
Partnership original basis in receivables	(0)
Partnership new basis in receivables	$15,000

Step 9: Ace's Basis in Land.

Ace's share of land in partnership	$15,000
Ace's deemed purchase of land	25,000
Ace's basis in land	$40,000

Final Result. Ace recognizes $15,000 of ordinary gain from the deemed sale of receivables in the year of the distribution. If he sells the land for $50,000, he recognizes $10,000 of gain in the year of sale.

The partnership recognizes $10,000 of gain on the deemed land sale in the year of distribution. This gain passes through to the remaining partners and increases each of their capital accounts by one-third of $10,000. The partnership's balance sheet after the distribution is shown below.

	Adjusted Basis	FMV
Assets		
Cash	$40,000	$ 40,000
Receivables	15,000	60,000
Land	30,000	50,000
Total	$85,000	$150,000
Liabilities and equity		
Ace: 25%	$ 0	$ 0
Bart: 25%	28,333	50,000
Candy: 25%	28,333	50,000
Donna: 25%	28,334	50,000
Total	$85,000	$150,000

Disproportionate Distributions of Hot Assets

If a disproportionate distribution of hot assets is made and it results in a deemed sale or exchange under §751(b), both the partnership and the distributee partner are required to include a statement with their respective returns for the year of the distribution which explains the computation of any resulting income, gain, or loss.[168]

The distributee partner's statement is also required to include information which lists the following:

1. Date of the distribution
2. Adjusted tax basis of their partnership interest
3. Amount of any money or value of any non-§751(b) property received
4. Election and computation of their adjusted tax basis in §751(b) property under §732(d) (if otherwise applicable)
5. Allocation and computation of special basis adjustments to partnership properties under §743(b) (if otherwise applicable)[169]

Caution. There can be different variations on disproportionate dissolutions. For example, Ace could have taken all of the receivables and no land, or he could have simply reduced his percentage of partnership ownership. These transactions result in different calculations.

168. Treas. Reg. §1.751-1(b)(5)

169. Treas. Regs. §§1.751-1(b)(5) and 1.751-1(a)(3)

TECHNICAL TERMINATIONS — EFFECT ON DEPRECIABLE PROPERTY

Technical termination of a partnership occurs when there is a sale or exchange of 50% or more of the total interest in partnership capital and profits within a 12-month period.[170]

Observation. If the technical termination occurs under §708(b)(1)(B), it normally does not result in the partnership ceasing to exist under state law and, normally is followed by a reformation of the partnership. As a result, a reformation often goes unnoticed by the partners and other third parties because virtually nothing (except for the tax ramifications changes).

A SHORT-YEAR TAX RETURN

When a technical termination occurs, the partnership is required to file a short-year final return for the tax year ending with the termination date. Likewise, the new partnership is required to file a return for its tax year beginning after the date of termination.[171] However, the new partnership is permitted to use the same EIN as the terminated partnership.[172]

Observation. The IRS stated that when the partnership fails to file these two separate short-year tax returns and only files a single return for the entire 12-month period, the statute of limitations is deemed to begin running for both short tax years.[173]

DEEMED CONTRIBUTION OF ASSETS IN EXCHANGE FOR INTERESTS IN NEW PARTNERSHIP

The terminated partnership is deemed to contribute all of its assets to a new partnership in exchange for all the interests in the new partnership. The terminated partnership is deemed to have distributed the interests in the new partnership to its partners, which are received in proportion to their respective interests in the terminated partnership.[174]

IMPACT OF TECHNICAL TERMINATION ON THE PARTNERSHIP'S DEPRECIABLE ASSETS

IRC §168(i)(7) lists five specific tax-deferred types of transactions where the transferee "steps into the shoes" of the transferor regarding the depreciable lives and methods of the assets that flows to the new entity. The transferee takes over the Form 4562 information from the transferor and continues to deduct the assets as though nothing occurred.

There can be significant tax consequences related to depreciable property when the technical termination[175] occurs due to 50% or more of the partnership interests being transferred within a 12-month period, as opposed to when the partnership decides to go out of business and distributes its assets to the partners. The last sentence of §168(i)(7) specifically states that "shoes depreciation" does not apply in this instance.

The result is that a partnership might have numerous assets with significant adjusted bases remaining in each. Yet, the new partnership that is deemed to come into existence is forced to start a totally new recovery period for each asset transferred. Especially with real estate, this leads to disastrous results from a tax standpoint. For example, commercial realty, which normally has a 39-year recovery period, must start a "fresh" recovery period of 39 years (regardless of how many years the asset has already been depreciated) and use this for the adjusted tax basis that remained on that asset.

170. IRC §708(b)(1)(B)
171. Notice 2001-5, January 21, 2001
172. Treas. Reg. §301.6109-1(d)(2)(iii)
173. FSA 200132009, May 4, 2001
174. Treas. Reg. §1.708-1(b)(4)
175. IRC §708(b)(1)(B)

Example 47. Technical Terminations Might Mean a "Fresh Start" Recovery Period for the New Partnership. ABCD Partnership is now owned as follows: Aaron and Brad each own 30%, and Cathy and Diane each own 20%. Aaron and Brad want to retire. They receive a cash distribution from the partnership in complete liquidation of their partnership interest. The partnership is forced to refinance its only asset, a commercial building which it leases to an outside third party. Since 50% or more of the partnership interests were transferred within a 12-month period, a technical termination is deemed to have occurred. Even if a §754 election is in effect, so that a portion of the building's basis is stepped up due to any gain recognized by the exiting partners, the entire building basis must now be recovered by the CD Partnership using a "fresh" 39-year recovery period.

Note. The result is the same if Aaron and Brad sold their combined 60% interest in the partnership to new partners, Earl and Frank. This still results in a technical termination, and has the same impact on the depreciable assets that now are owned by CDEF Partnership.

Observation. Even though a fresh recovery period is assigned to each asset in the newly formed partnership, care must be taken to keep track of all depreciation which was already taken. In **Example 44,** only a commercial piece of real estate is held by the partnership. Consequently, there is a good chance that S/L depreciation was used. Therefore, §1250 recapture might not come into play. However, there is still a significant amount of "unrecaptured §1250 gain" subject to a 25% tax rate when the building is disposed of in a taxable transaction.