Chapter 4: Partnerships

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Corrections were made to this material through January of 2012. No subsequent modifications were made.

Subchapter K of the Internal Revenue Code is one of the most complex and often misunderstood parts of present-day tax law. Transferring amounts from a Form 1065, Schedule K-1, to a Form 1040 appears to be very simple. Unfortunately, in many instances the amounts reported on the K-1 are not the amounts that are supposed to be reported on the Form 1040. The reasons for much of the complexity are the basis, passive loss, and at-risk rules.

In a 1964 complex partnership tax case, the Tax Court judge stated, "The distressingly complex and confusing nature of the provisions of Subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field." The judge went on to say, "Surely, a statute has not achieved 'simplicity' when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries."[1]

Numerous tax acts have occurred since 1964, and the complexity of Subchapter K continues to increase.

Note. The content of this chapter is written for general partnerships. When the content also applies to LLCs, it is specifically noted.

PARTNERSHIP AGREEMENTS

There are no requirements that a partnership have a written partnership agreement. In fact, many existing partnerships do not have a formal agreement. Unfortunately, when a disagreement occurs among the partners, it may take a court to settle the dispute. The result from a court order may not be in any of the partners' best interests. In the absence of any type of written partnership agreement, state partnership law controls.[2]

The best time to write the partnership agreement is when the new venture is being planned. While individuals are often excited and want to begin the business as soon as possible, they need to spend additional time and put their thoughts on paper. If the partners ever decide to terminate the business, they may be under stress and not make the wisest decisions. Some important issues for the partnership agreement to address are shown on the following page.

1. *Foxman et al v. Comm'r,* 41 TC No. 535 (Jan. 16, 1964).
2. *Holdner et al. v. Comm'r,* TC Memo 2010-175 (Aug. 4, 2010).

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1. **Name of the business.** This may be one of the most difficult decisions the new partners have to make. If they are using the surnames of the partners, in what order do they list the names? If they are going to "coin" a name, what will it be? Many partnerships have failed to get off the ground over the choice of a name.
2. **Capital contribution.** How much money or property will each partner contribute to the partnership? If property is contributed, who will establish the fair market value (FMV)? FMV **must** be established. What will happen if the partnership needs additional capital in the future? Can a partnership interest be obtained by the contribution of services?
3. **Profit or loss allocation.** How will the profits and losses of the business be divided? If there are profits, will they be directly distributed to the partners, or will part of the profits be retained as future working capital? If there are losses, will each partner need to make an additional capital contribution to cover their portion of the loss?
4. **Guaranteed payments.** Will the partners who provide services to the partnership receive a payment for their services before the partnership distributes any additional money to the partners?
5. **Management duties and restrictions.** Who will make the management decisions for the partnership? Will it be an individual partner, a committee of partners, or all of the partners? What if the partners do not agree? Who has the right to contract for the partnership? Is there a dollar limit on the amount a partner can spend for the partnership without approval of the other partners?
6. **Books and records.** Who will maintain the books and records of the partnership? What access do the other partners have to the books?
7. **Tax matters partner.** Who is responsible for filing the state and federal tax returns? Who can bind the partnership in the event of an income tax audit?
8. **Transfer of interests.** Can a partner transfer their interest to another person without partnership approval?
9. **Buy/sell agreement.** What happens if a partner dies, wants to retire, or becomes disabled? How will a purchase price be established? What will the payment terms be?

FORMATION ISSUES

CONTRIBUTION OF PROPERTY

The easiest method to use to form a partnership involves all partners contributing only cash. However, this rarely occurs. Frequently, one or more partners contribute assets other than money. In addition, a partner may contribute an asset that is subject to a liability. This can lead to a tax liability for the contributing partner upon partnership formation.

IRC §721 controls the formation of a partnership. **Neither gain nor loss is recognized** by a partnership or its partners on the contribution of property to the partnership in exchange for a partnership interest.[3] There is an exception in the case of a partnership that would be treated as an investment company if it were incorporated.[4]

3. IRC §721(a).
4. IRC §721(b).

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Example 1. Rose and Ainsley form a partnership. The table below shows their contributions.

	Rose		Ainsley		Partnership	
Contributions	**Adjusted Basis**	**FMV**	**Adjusted Basis**	**FMV**	**Adjusted Basis**	**FMV**
Cash	$16,000	$16,000	$ 0	$ 0	$16,000	$16,000
Equipment	0	0	13,000	16,000	13,000	16,000
Total	$16,000	$16,000	$13,000	$16,000	$29,000	$32,000

Because Rose and Ainsley each contributed $16,000 of assets, they each own 50% of the capital of the partnership. Rose has a capital account balance of $16,000, which is her inside basis.[5] Ainsley has a capital account of $13,000, which is her inside basis. The basis of the equipment in the partnership is $13,000.[6]

HOLDING PERIOD

If a partner contributes property to a partnership, the holding period of the new partnership interest is the same as the holding period of the contributed asset.[7] If a partner contributes cash to the partnership, the holding period of the partnership interest begins the day the cash is contributed.

The partnership continues with the holding period of the asset as held by the partner.[8]

CONTRIBUTION OF LIABILITIES

The contribution of liabilities complicates the determination of the basis of a partnership interest. In a partnership, an assumption of debt by the partnership is treated as a distribution of cash to the partner.[9] The assumption of debt by a partner is treated as a contribution of cash.[10] Each partner is liable for their share of all partnership liabilities.

Example 2. For a 50% interest in the partnership, Trevor contributes to the partnership land with an FMV of $50,000 and a basis of $40,000 subject to a $30,000 recourse mortgage. The partnership is deemed to have assumed the $30,000 debt. IRC §721(a) applies, which protects Trevor from the recognition of gain on the contribution. Because Trevor is a 50% partner, he is responsible for half, or $15,000, of the debt. Therefore, the $15,000 of debt relief reduces his basis in his partnership interest to $25,000. The other partners are deemed to have assumed the remaining $15,000 of the contributed liability.

Beginning basis	$ 0
Basis of assets contributed	40,000
Debt assumed by partnership	(30,000)
Trevor's share of partnership debt	15,000
Trevor's basis of partnership interest	$25,000

If liabilities are transferred into the new partnership, the contributing partner may have a tax liability. If the partner has liabilities in excess of the contributed property's basis, the partner must recognize gain on the transaction.[11] This occurs because the other partners in the partnership are deemed to have assumed a portion of the liabilities.

5. IRC §722.
6. IRC §723.
7. IRC §1223(2).
8. Ibid.
9. IRC §752(b).
10. IRC §752(a).
11. IRC §§752(b) and 731(a)(1).

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Example 3. Use the same facts as **Example 2,** except Trevor had a $90,000 loan on the land he contributed.

Beginning basis	$ 0
Basis of assets contributed	40,000
Debt assumed by partnership	(90,000)
Trevor's share of partnership debt	45,000
Basis of contribution	($ 5,000)
Gain recognized on contribution	5,000 [a]
Basis of partnership interest	$ 0

[a] §1231 gain

BASIS IN PARTNERSHIP INTEREST

Some tax preparers believe the basis of a partner is the same as their ending capital account, which may or may not appear on the Schedule K-1.

Example 4. Maxine received the following Schedule K-1 from a partnership in which she is a 10% owner.

Part II Information About the Partner

E Partner's identifying number
123-45-6789

F Partner's name, address, city, state, and ZIP code
Maxine Taxpayer
21 Vine St
Anytown, IL 66666

G [X] General partner or LLC member-manager [ ] Limited partner or other LLC member

H [X] Domestic partner [ ] Foreign partner

I What type of entity is this partner? **Individual**

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	10 %	10 %
Loss	10 %	10 %
Capital	10 %	10 %

K Partner's share of liabilities at year end:

Nonrecourse	$
Qualified nonrecourse financing	$
Recourse	$ 25,000

L Partner's capital account analysis:

Beginning capital account	$
Capital contributed during the year	$
Current year increase (decrease)	$
Withdrawals & distributions	$ ( )
Ending capital account	$

[ ] Tax basis [ ] GAAP [ ] Section 704(b) book
[ ] Other (explain)

M Did the partner contribute property with a built-in gain or loss?
[ ] Yes [X] No
If "Yes," attach statement (see instructions)

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Notice that Part II of the K-1 in **Example 4** is completed except for Item L. Unfortunately, this information is necessary for the partner's tax preparer. Therefore, the partner or the preparer must track this information.

The basis of a partnership interest has two components. There is an **inside basis** and an **outside basis**. Frequently these amounts are the same; however, this is not always the case. **A partner's inside basis consists of their share of the basis of the assets held by the partnership.** This is the capital account of the partner and is shown in Item L on Schedule K-1. **The outside basis is the basis of the assets contributed to the partnership plus or minus adjustments.** The adjustments include any changes in the partner's share of the partnership liabilities.[12] This is the basis of the partner's partnership interest. The outside basis is used when assets are distributed to the partner or when the partnership dissolves.

Example 5. Geno is an original owner of G & L Partnership. Geno contributed to the partnership a building lot having an FMV of $30,000 and a basis of $10,000. This is all Geno contributed. His inside basis is $10,000 and his outside basis is also $10,000.

Knowing the partner's correct basis in their partnership interest is important for the following reasons.

1. A partner can withdraw cash from the partnership without incurring a tax liability to the extent of their outside basis.
2. A partner may deduct losses on their personal return only to the extent of their outside basis.
3. Generally, gain is not recognized to the distributee partner with respect to distributed property, regardless of the value of the property distributed in relation to the distributee's adjusted basis for the partnership interest. On the sale or exchange of a partner's interest, outside basis is used to determine the gain or loss on the sale.
4. A partner's estate receives a step up in basis to its FMV upon the death of the partner.

A partner's beginning basis is affected by the manner in which the partner acquires the partnership interest. If the partnership interest is acquired by purchase, the outside basis is the purchase price.

Example 6. The next day after Geno's contribution in **Example 5,** Jill offered to purchase Geno's partnership interest for $30,000. Jill has the same $10,000 inside basis as Geno but her outside basis is $30,000, the purchase price.

5. If the partnership interest is acquired by gift, the basis is the same as the basis of the donor. If the donor has suspended passive losses at the time of the gift, the **suspended losses increase** the basis to the donee. Any losses suspended because of the at-risk rules or lack of basis do not pass to the donee. These tax attributes remain personal to the donor and stay suspended until such time as the donor has sufficient basis to deduct them.

Example 7. Yolanda's father gives Yolanda a gift of a portion of a partnership interest he currently holds. At the time of the gift, her father's basis in this portion of the interest is $20,000. Father is a passive investor in the partnership and has $4,000 of suspended passive losses allocable to his share of the partnership interest. Yolanda will have a carryover basis of $20,000 in the partnership interest plus the $4,000 of suspended passive loss, for a total outside basis of $24,000.

6. If the partnership interest is acquired by inheritance, the basis is the FMV of the partnership interest in the decedent's estate. This is the date-of-death FMV or the FMV on the alternate valuation date. If the deceased has suspended losses, the suspended losses increase the basis to the beneficiary but only if they are greater than the step up in basis.

[12] IRC §752.

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Example 8. Use the same facts as **Example 7,** except Yolanda inherits the partnership interest at the time of her father's death. The interest is valued at $30,000 at the time of death and her father's basis immediately before his death was $20,000. Therefore, there is a $10,000 step up in basis. At the time of death, $4,000 of suspended passive losses was attributable to the interest. Because the step up in basis is greater than the suspended losses, Yolanda **does not** receive any benefit from the suspended losses. The $4,000 of suspended losses is lost forever.

Assume the suspended passive loss was $15,000. In this case, the suspended loss exceeds the step up in basis by $5,000 (15,000 − $10,000). Yolanda receives the benefit of the $5,000 suspended loss and her outside basis in the partnership interest equals $35,000 ($30,000 + $5,000).

Note. In all three examples, the new partner's inside basis is the same as the basis of the seller, donor, or decedent.

CALCULATING BASIS

Items on Form 1065, Schedule K-1, carry to various locations on the taxpayer's Form 1040. If the K-1 shows a loss, the taxpayer needs to ensure that the loss is deductible. **The loss is deductible if:**

- The loss does not exceed the basis in the taxpayer's ownership interest, and
- The basis in the ownership interest is "at risk."

Even if the basis is at risk, the loss could be limited if it is passive.

Observation. It is important for the taxpayer to keep track of basis. The K-1 may be of little help in many situations.

Components of Basis

The computation of basis begins with the taxpayer's initial investment in their ownership interest. Basis is **increased by:**

- Taxable income which is reported on lines 1–13 of Form 1065, Schedule K-1;
- Tax-exempt income that is reported on line 18 of Form 1065, Schedule K-1; and
- Capital contributions reported at item L of the K-1.

Basis is **reduced by:**

- Deductible expenses;
- Permanently nondeductible expenses reported on line 18 of Form 1065, Schedule K-1; and
- Distributions reported on line 19 of Form 1065, Schedule K-1.

If losses exceed basis, they are limited to basis. If the taxpayer has multiple deduction items, they must be prorated so the total does not exceed the taxpayer's basis.

Basis in a partnership also includes the taxpayer's share of debts the partnership owes. If the partnership return is prepared properly, the return reports each partner's share of debt on line K of Form 1065. This amount is "inside" partnership debt and gets added to the partner's basis in the partnership interest.

Observation. A partner's "capital account analysis" shown on item L of the K-1 should not be used as a means of computing basis. A partner should track their own basis annually.

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At Risk

As noted previously, basis must be considered to be "at risk" in order to provide any current tax benefit to the partner. Because basis in a partnership interest can result from borrowings by the partnership, it may not be at risk. The at risk rules defer losses attributable to basis that is not at risk. On the Schedule K-1, the partner's share of debt is broken down at item K into three categories. Item K provides for a listing of the recourse and nonrecourse liabilities of the partnership. **Nonrecourse liabilities** are typically not at risk, but **qualified nonrecourse financing** (typically debt from commercial lenders or government agencies) is deemed to be at risk.

If losses exceed the partner's other basis, the partner must compute the at risk disallowance on Form 6198, *At-Risk Limitations*. Once that is accomplished, a determination must be made as to whether any resulting deduction is limited by the passive loss rules.

LOSSES IN EXCESS OF BASIS IN PARTNERSHIP INTEREST

It is possible for a partner's distributive share of the aggregate from separately stated items (e.g., the sale or exchange of property, capital losses, investment interest expense, and nonseparately stated trade or business losses from Form 1065) to exceed the basis of the partnership interest. If this occurs, the overall limitation on losses[13] must be allocated to the partner's distributive share of each loss. The 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 any losses disallowed and carried forward from the prior years.[14]

Example 9. At the beginning of the year, Alice has a $6,000 basis in her partnership interest. As of the end of the current partnership year, Alice has the distributive share of partnership items shown here.

§1231 loss	($12,000)
Short-term capital loss	(6,000)
Nonseparately stated income	5,000

At the end of the year, Alice's basis is calculated as shown.

Beginning basis	$ 6,000
Nonseparately stated income from Form 1065, page 1	5,000
Total	$11,000

Because Alice's share of losses exceeds her basis ($18,000 exceeds her basis of $11,000) she must prorate the losses against the basis.

	Total	Allocation Calculation	Deductible Loss	Carryover
§1231 loss	($12,000)	($11,000 ÷ $18,000) × $12,000	($ 7,333)	($4,667)
Short-term capital loss	(6,000)	($11,000 ÷ $18,000) × $6,000	(3,667)	(2,333)
Total losses	($18,000)		($11,000)	($7,000)
Remaining basis			$ 0	

Note. Any item which could have a varying tax effect from one partner to another must be separately stated on the Schedule K-1. This includes any item that might:

- Receive special treatment,
- Be subject to separate limits at the partner level, or
- Affect the partner's AMT calculation.

13. IRC §704(d).

14. Treas. Reg. §1.704-1(d)(1).

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EFFECT OF NONDEDUCTIBLE EXPENSES AND NONTAXABLE RECEIPTS

The capital account reflects the economic relationships among the various partners. As a result, capital account adjustments do not necessarily track the tax information shown on the Schedule K-1. Accordingly, the disallowed portion of expenses such as meals and entertainment or country club dues paid by the partnership still reduce the partner's capital account in full. Conversely, a partner's distributive share of tax-exempt income increases the partner's capital account even though it is never included in gross income on the partner's individual tax return.[15] These adjustments are appropriate because capital accounts are intended to correspond to the partnership agreement on how to allocate economic gain or loss.[16]

LOANS FROM INDIVIDUAL PARTNERS

Generally, **loans to the partnership from a partner increase the outside basis of each partner proportionately.** However, this is not the case for a limited partner or a member of an LLC taxed as a partnership. These individuals, by definition, are only liable for loans they have personally guaranteed.

OTHER LIMITATION ON LOSS DEDUCTIBILITY

In addition to the possibility of suspended losses due to insufficient basis, a partner may also be limited in deducting losses due to the at-risk and passive loss rules.

Note. An extensive discussion of at-risk and passive loss limitations for pass-through entities can be found in the 2010 *University of Illinois Federal Tax Workbook,* beginning on page 21. This can be found on the accompanying CD.

IRC §704 SPECIAL ALLOCATIONS

As an entity, a partnership does not pay income taxes. All of its profits and losses are passed to the partners on the Schedule K-1. IRC §704 determines how the allocations are made between the partnership and the partners, which is referred to as the "distributive share." Basically, §704 directs allocations to be made in accordance with the partnership agreement.[17] The distributions are made in accordance with the partner's interest in the partnership by taking into account all applicable facts and circumstances[18] if the:

- Partnership agreement is silent in regard to the distributive share,[19] or
- Allocation to a partner under the agreement does not have substantial economic effect.[20]

ECONOMIC EFFECT

In order to have **economic effect**, the allocation must be consistent with the underlying economic arrangement of the partners. This means the agreement affects the amount the partner receives upon liquidation of the entity. If there is an economic benefit or burden that corresponds to the allocation, the member to whom the allocation is made must receive that benefit or bear that burden.

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15. Treas. Reg. §1.704-1(b)(2)(iv)(b).
16. Treas. Reg. §1.704-1(b)(2)(ii)(a).
17. IRC §704(a).
18. IRC §704(b).
19. IRC §704(b)(1).
20. IRC §704(b)(2).

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The allocation has an economic effect only if, throughout the full term of the partnership, the partner agreement provides the following.[21]

1. For determination and maintenance of the capital accounts within the capital accounting rules,[22] the capital account is **increased by:**
   a. The money contributed by the partner to the partnership,
   b. The FMV of property contributed (net of liabilities), and
   c. The allocations to the partner of partnership income and gain.
2. The capital account is **decreased by:**
   a. The amount of money distributed to the partner,
   b. The FMV of property distributed (net of liabilities that the partner is considered to assume), and
   c. The allocation of expenditures of the partnership and allocations of partnership loss and deductions.

Note. If a partner has more than one partnership interest, a single capital account must reflect all such interests.

3. On liquidation of the partnership (or any partners' interest in the partnership), liquidating distributions must be made in accordance with the positive capital account balances of the partners.[23]
4. If the partner has a deficit balance, they must be unconditionally obligated to restore the amount of the deficit to the partnership by the end of the taxable year.[24]

Substantial Economic Effect

The economic outcome of an allocation is **substantial** when there is a reasonable possibility that the allocation substantially affects the dollar amounts received by the partners from the partnership.[25] The economic effect is **not substantial** when, at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that the following situations may occur.

1. The net increases and decreases that will be recorded in the partners' respective capital accounts will not differ substantially from the net increases and decreases that would be recorded if the allocations were not contained in the partnership agreement.[26]
2. The total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement.[27]

Absent the special rules of IRC §704(c), precontribution tax consequences for contributed property are taken into account.[28] This means that any gain, loss, or depreciation is shared according to the general profit-sharing ratio. Due to the carryover basis for contributed property, this can lead to economic inequality between the partners.

21. Treas. Reg. §1.704-1(b)(2)(ii)(b)(1).
22. Treas. Reg. §1.704-1(b)(2)(iv)(a).
23. Treas. Reg. §1.704-1(b)(2)(ii)(b)(2).
24. Treas. Reg. §1.704-1(b)(2)(ii)(b)(3).
25. Treas. Reg. §1.704-1(b)(2)(iii)(a).
26. Treas. Reg. §1.704-1(b)(2)(iii)(b)(1).
27. Treas. Reg. §1.704-1(b)(2)(iii)(b)(2).
28. IRC §704(c).

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Example 10. Anna contributed equipment with a basis of $20,000 and an FMV of $80,000 to a new partnership. The other partner contributed $80,000 cash. Shortly after the contribution, the partnership sold one of the items of equipment for $4,000, which had a basis at the time of contribution of $1,000. The gain of $3,000 ($4,000 − $1,000) should be specially allocated to Anna because she received all of the precontribution tax benefits of the depreciation and precontribution gain.

Example 11. In a 50-50 father-son partnership, the son purchased $50,000 of raised dairy cows from the father prior to the partnership's formation. The purchased cows became the son's contribution to the new partnership. Father contributed another $50,000 of raised dairy cows (§1231 assets). Depreciation of the cows will be shared equally between father and son barring any special allocation in the partnership agreement. The father and the son have different marginal tax rates.

In an attempt to prevent income shifting, the Tax Reform Act of 1984 requires an allocation of gain or loss back to the contributing partner for contributions made after May 1, 1986, under IRC §704(c) regulations.[29] Other means of taking into account precontribution gain, loss, or depreciation include the following.

1. Sale of the contributed assets to the partnership
2. Sale of the contributed assets to other partners
3. Lease of the contributed assets to the partnership

The IRS issued amended Treas. Reg. §1.704-1 with TD 9398 on May 16, 2008, for partners that are pass-through entities or members of consolidated groups. The amendments are effective for tax years beginning on or after May 16, 2008.

IRC §704(c)(1)(A) states:

> *Under regulations prescribed by the Secretary, income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among partners so as to take account of the variation between the basis of the property to the partnership and its FMV at the time of contribution.*

The House Committee Report made it relatively clear that Congress wanted to prevent an artificial shifting of tax consequences between partners who are in different tax brackets. In **Example 11,** gain is allocated to a partner in a lower tax bracket (the son) by sharing depreciation deductions on contributed property with the higher-taxed partner (his father). If the depreciation is not specifically allocated to the son, the depreciation allocated to the father would help offset the gain he recognized on the sale of the dairy cows.

These rules are set forth in Treas. Regs. §§1.704-3(e)(1)(i) and (ii). They state that if a partner contributes one or more items of property to a partnership within a partnership's single taxable year and the disparity between the property's book value and the contributing partner's adjusted tax basis in the property is a **small disparity,** the partnership may do one of the following.

1. Use a reasonable IRC §704(c) method.
2. Disregard the application of §704(c) to the property.
3. Defer the application of §704(c) to the property until the disposition of the property.

A disparity between the FMV at the time of contribution and the adjusted tax basis is a **small disparity** if the book value of all properties contributed by one partner during the tax year does not differ from the adjusted tax basis by more than 15% of the adjusted tax basis, and the total gross disparity does not exceed $20,000.[30]

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.

29. Tax Reform Act of 1984, §71 and Committee Report.

30. Treas. Reg. §1.704-3(e)(1)(ii).

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Accrued, but unpaid, items of income or deduction of a cash-method partner that are contributed to or assumed by the partnership are treated the same as any other §704(c) property. In effect, these rules require that when partner-contributed accounts payable are paid, the expense is not deducted by the partnership but is allocated to the contributing partner. Similarly, when partner-contributed accounts receivable are received, the taxable income is not included in partnership taxable income but is allocated to the contributing partner.

Final and proposed regulations concerning §704(c) were issued December 21, 1993, and describe three methods of making §704(c) allocations.

1. Traditional method
2. Traditional method with curative allocations
3. Remedial allocation method

IRC §704(c) property is defined as property that at the time of contribution has an FMV that differs from the contributing partner's adjusted tax basis.[31]

Generally, regulations require an allocation to correct differences on a property-by-property basis. However, an aggregation of properties contributed by one partner in a tax year is allowed.[32] Therefore, depreciable items in the same general asset account, zero-basis property, and inventory may be aggregated into separate groups for the purposes of determining §704(c) allocations.[33]

When making allocations, different methods may be used for different items or aggregation of items.

Note. The regulations state that a specific selected method is not unreasonable just because another method would result in a greater overall tax liability.[34]

Example 12. Francine and Martha form an equal partnership. Francine contributes a depreciable asset with an adjusted tax basis of $100,000 and a $200,000 FMV at the time of contribution. Martha contributes $200,000 cash. If the depreciable asset is ever sold by the partnership, the precontribution gain of $100,000 is allocated to Francine to the extent that no special allocation of depreciation was made to Martha.

Allocation Methods

If the property has depreciation deductions, the deduction may be allocated in one of the three ways.

1. Traditional Method. To understand allocations, it must be recognized that two capital accounts exist. One is the partner's book capital account and the other is the capital account inside the partnership, which is composed of the basis of the contributed partnership assets.

Example 13. Samuel and Jonathon form a partnership. Samuel contributes equipment with a basis of $25,000 and an FMV of 85,000. Samuel has a book capital account of $85,000 and a partnership basis of $25,000. Jonathon contributes $85,000 cash. Jonathon has a book capital account of $85,000 and a partnership basis of $85,000.

	Partnership Basis	Book Capital Account
Samuel	$25,000	$85,000
Jonathon	85,000	85,000

31. Treas. Reg. §1.704-3(a)(3)(i).
32. Treas. Reg. §1.704-3(a)(2).
33. Treas. Reg. §1.704-3(e)(2).
34. Treas. Reg. §1.704-3(a)(1).

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The purpose of the special allocations under §704 is to equalize the partners' inside basis through the allocation of gains and losses.

Example 14. Use the same facts as **Example 13.** The equipment contributed by Samuel has a 10-year life. Therefore, the partnership recognizes $2,500 of tax depreciation each year. However, there will be $8,500 of book depreciation. The partnership depreciation will be allocated to Jonathon and the book depreciation will be split equally between Samuel and Jonathon.

The special allocation is shown on the following Schedule K-1 for Jonathon.

Part II Information About the Partner

E Partner's identifying number

F Partner's name, address, city, state, and ZIP code
Jonathon

G [X] General partner or LLC member-manager [ ] Limited partner or other LLC member

H [X] Domestic partner [ ] Foreign partner

I What type of entity is this partner? **Individual**

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	50 %	50 %
Loss	50 %	50 %
Capital	50 %	50 %

9a Net long-term capital gain (loss)
9b Collectibles (28%) gain (loss)
9c Unrecaptured section 1250 gain
10 Net section 1231 gain (loss)
11 Other income (loss)
12 Section 179 deduction
13 Other deductions
W **Statement**

17 Alternative minimum tax (AMT) items
18 Tax-exempt income and nondeductible expenses
19 Distributions
20 Other information

Statement 1

Jonathon

Box 13

W Specially allocated depreciation $2,500

Assuming no other activity, the capital accounts at the end of first year are:

	Partnership Basis	Book Capital Account
Samuel	$25,000	$80,750
Jonathon	82,500	80,750

Some taxpayers discovered a loophole in §704. By contributing built-in loss property along with built-in gain property, they could duplicate the built-in losses by liquidating the contributor's interest prior to realizing the built-in loss. The loss would be realized by the contributing partner on the liquidation of their interest, and the remaining partners would realize the loss when the property was sold. Congress tried to close this loophole in the American Jobs Creation Act of 2004. They enacted IRC §704(c)(1)(C), which states that such built-in losses are taken into account only in determining the amount of items allocated to the contributing partner and in determining the amount of items allocated to other partners. The basis of the contributed property in the hands of the partnership is treated as being equal to its FMV at the time of contribution.

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The traditional method is limited in its ability to eliminate the differences created by the contribution of appreciated property due to the **ceiling rule.**

The ceiling rule prevents the partnership from allocating more gain, loss, depreciation, or depletion than is recognized for tax purposes. Therefore, in some cases, the tax allocations to noncontributing partners may not equal their book allocations. Therefore, book depreciation for the noncontributing partner **can** exceed the total tax depreciation.

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.

2. Traditional Method with Curative Allocations. To correct distortions created by the ceiling rule, a partnership using the traditional method may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. **A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item.** For example, if a noncontributing partner is allocated less tax depreciation than book depreciation for an item of §704(c) property, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference. This is notwithstanding that the corresponding book depreciation is allocated to the contributing partner. A partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from a specific property or properties) even if the allocation of those available items does not fully offset the effect of the ceiling rule.[35]

The partnership must be consistent in its application of curative allocations for each item of §704(c) property from year to year.[36]

A curative allocation is not reasonable to the extent it exceeds the amount necessary to offset the effect of the ceiling rule for the current taxable year or, in the case of a curative allocation upon disposition of the property, for prior taxable years.[37]

The period of time over which the curative allocations are made is a factor in determining whether the allocations are reasonable. A partnership may make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year if those allocations are made over a reasonable period of time, such as over the property's economic life, and are provided for under the partnership agreement in effect for the year of contribution.[38]

To be reasonable, these allocations must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. For example, a depreciation shortfall for a noncontributing partner could be corrected by an allocation of depreciation from the contributing partner's share. It could also be corrected by an allocation of ordinary income from the noncontributing partner to the contributing partner to offset the shortfall.[39] The partnership may limit its curative allocations to allocations of one or more particular tax items even if the allocation of those available items does not fully offset the effect of the ceiling rule.

Note. The partnership must be consistent in its application of curative allocations for each item of §704(c) property from year to year.[40]

35. Treas. Reg. §1.704-3(c)(1).
36. Treas. Reg. §1.704-3(c)(2).
37. Treas. Reg. §1.704-3(c)(3)(i).
38. Treas. Reg. §1.704-3(c)(3)(ii).
39. Treas. Reg. §1.704-3(c)(3)(iii).
40. Treas. Reg. §1.704-3(c)(2).

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3. Remedial Allocation Method. The remedial allocation method[41] carries the traditional method with curative allocations a step further to eliminate distortions caused by the ceiling rule. The procedure creates remedial items and makes tax allocations between the partners to correct the differences between book and tax allocations even when the contributed property no longer requires any tax allocations.[42] Presumably, **adoption of this method ultimately corrects all differences between the partners in their proportionate share of the partnership tax basis and book value.**

Contributed Property

There are times when special allocations to partners are required. There are tax consequences to the contributing partner when contributed property that has a basis different than its FMV at the time of contribution is distributed to a partner other than the contributing partner within **seven years** of contribution. **The contributing partner must recognize any gain or loss which would have been allocated to the partner if the property had been sold at its FMV at the time of contribution.**[43]

Example 15. Thury contributes land with a $100,000 basis and an FMV of $500,000 plus other assets having a $300,000 basis and an FMV of $400,000. Maier contributes $500,000 cash for his partnership interest. Three years after the contribution, Maier receives the land in a nonliquidating distribution of his partnership interest. Maier has a $500,000 basis in the land. However, Thury must recognize $400,000 of gain because the property was distributed in less than seven years. Thury increases his partnership basis by $400,000.

Note. When a partner contributes property to a partnership and the property has a built-in gain or loss, Item M on the partner's K-1 must be completed. If there was a built-in gain, a schedule must be attached showing the details of the contribution.

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☐ No
If "Yes," attach statement (see instructions)

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IRC §754 ELECTION

The purpose of the §754 election is to allow a partnership to adjust the inside basis of partnership assets to equal the outside basis of the interest. This issue commonly occurs when a partnership interest is sold, the death of a partner occurs, or there is a distribution of partnership assets.

Tax practitioners often find the IRC §754 election confusing. In reality, it is very simple. It states:

> *If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.*[44]

41. Treas. Reg. §1.704-3(d)(2).
42. Treas. Reg. §1.704-3(d)(1).
43. IRC §704(c)(1)(B)(i).
44. IRC §754.

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IRC §754 permits the taxpayer to make basis adjustments using §734(b) or §743(b). IRC §734(b) is used in connection with partnership **distributions** and IRC §743(b) is used in connection with the **transfer of partnership interests.** A very important provision in §754 indicates that once the election is made, it is **irrevocable without IRS permission.** Therefore, the practitioner must look at the current benefits of the election and anticipate any partner changes in the future. The §754 election cannot be selective. It must cover both the §§734(b) and 743(b) adjustments.

PREREQUISITES TO A BASIS ADJUSTMENT

The general rules providing for basis adjustments are contained in IRC §§743 and 734. The rules can be divided into two categories.

1. Adjustments made by the partner
2. Adjustments made by the partnership

IRC §743 — Partner Adjustments

IRC §743(a) does not allow basis adjustments unless a §754 election is in effect.[45] The IRC §743(b) adjustment is used if a §754 election is in effect or if there is a substantial built-in loss when assets are transferred either due to the death of a partner or a sale of a partnership interest.[46] The adjustment will:

- **Increase the adjusted basis** of the partnership assets by the excess of the basis of the **transferee partner's** interest less the transferee partner's proportionate share of the basis of the partnership property,[47] or
- **Decrease the adjusted basis** of the partnership assets by the excess of the **transferee partner's** proportionate share of the basis of the partnership property less the basis of the transferee partner's interest in the partnership.[48]

The basis adjustment only affects the transferee partner.

Example 16. Chandra purchases Alex's partnership interest in Hairport Partnership. Alex owned a 25% interest in the partnership. Alex's share of the basis of the partnership assets was $20,000 and his share of the FMV of the partnership assets was $30,000, all of which are depreciable. Chandra paid Alex $30,000 for the partnership interest. Therefore, she has a $30,000 outside basis in the interest with the inside basis remaining at $20,000. Making the §743(b) adjustment allows her to allocate the $10,000 excess of FMV over basis to the assets and take depreciation deductions that ultimately equalize the FMV and basis for her partnership interest.

Example 17. Reverse the facts in **Example 16.** The FMV of the partnership assets have declined and the FMV of the assets is less than the asset's basis. Chandra pays Alex $20,000 for his partnership interest and Alex's share of the basis in the partnership assets is $30,000. Because the §754 election is irrevocable, the partnership must make a $10,000 downward basis adjustment to the assets for Chandra. Therefore, Chandra receives $10,000 less depreciation than the other partners.

IRC §743(b) only determines the gross amount of the adjustment. The actual allocation of the adjustment to the partnership assets is controlled by IRC §755.

45. IRC §743(a).
46. IRC §743(b).
47. IRC §743(b)(1).
48. IRC §743(b)(2).

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IRC §734 — Partnership Adjustments

When partnership property is distributed to a partner, adjusting the basis of the remaining property is not generally permitted. If the remaining partners do not liquidate the partnership for many years and the distortion is great, the partners could find themselves having a large capital loss that is limited by the $3,000 excess capital loss rule.

IRC §734 offers some relief to the remaining partners. It does not come into play when assets are distributed by the partnership unless a §754 election is in effect or unless there is a substantial basis reduction due to the distribution.[49] If §734(b) applies, the partnership adjusts the basis of the remaining partnership property. The adjustment amount is calculated as follows.

1. If the distributee partner receives cash in excess of their partnership basis, the partner recognizes gain and the partnership increases the basis in the remaining partnership assets by the same amount.

Example 18. Colin is a partner in Irish Linens. His basis in the partnership is $50,000. The partnership distributes $60,000 cash to him. Colin recognizes a gain of $10,000 ($60,000 − $50,000) and the partnership increases the basis in its remaining assets by $10,000.

2. If the partner completely liquidates their partnership interest by **solely** receiving cash, accounts receivable, and inventory, and the basis of the distributed assets is less than the partner's basis, the partner recognizes a loss and the partnership must reduce its basis in the remaining assets.

Example 19. Colin from **Example 18** completely liquidates his partnership interest in Irish Linens for cash, accounts receivable, and inventory with a basis of $40,000. Because the basis in Colin's partnership interest is $50,000, he recognizes a $10,000 loss and the partnership reduces the basis in its remaining partnership assets by $10,000.

3. If the partner receives assets with a basis exceeding their basis in the partnership interest, the partner is limited in the basis they have in the distributed assets by the basis of the partnership interest. The partnership can increase the basis in its remaining assets by the excess of the basis of the distributed assets less the distributee partner's basis in their partnership interest. If the distributed asset is an interest in a partnership that does not have a §754 election in effect, the distributing partnership cannot increase the basis in its remaining assets.

Example 20. Colin from **Example 18** liquidates his partnership interest in Irish Linens for property with a $60,000 basis. Because the basis in Colin's partnership interest is $50,000, his basis in the assets is limited to $50,000. However, the partnership increases the basis in its remaining partnership assets by $10,000.

4. Upon the complete liquidation of a partnership interest, if the total basis of the distributed assets in the hands of the partner is greater than the total basis of the assets in the hands of the partnership, the basis in the remaining assets is decreased by the excess basis.

Example 21. In a complete liquidation of Colin's partnership interest, assume he has an $80,000 basis in his partnership interest. He receives property with a $60,000 basis. The basis of the property in Colin's hands is $80,000. Consequently, the partnership reduces its basis in the remaining partnership property by $20,000.

Note. Once the §754 election is effective, the adjustments made by §§743 and 734 are mandatory in succeeding years.

[49] IRC §734(a).

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IRC §755 ADJUSTMENT COMPUTATION

IRC §§734 and 743 only establish the amount of the gross basis adjustment. The allocation of the adjustment is covered in IRC §755, which states that any increase or decrease in the adjusted basis of partnership property under §§734(b) or 743(b) must be allocated in a manner which has the effect of reducing the difference between the FMV and the adjusted basis of partnership properties, or in any other manner permitted by the regulations.

However, a special rule exists in applying the allocation rules. Increases or decreases are made to the adjusted basis of partnership property arising from a distribution or transfer of an interest attributable to property. The adjustment is first divided between the two classes of assets described in IRC §755(b).

- §1221 capital and §1231 assets (capital gain property)
- All other property (ordinary income property)

The allocation must be to property of a like character, and the basis cannot be reduced below zero. If like property does not exist or it does not have any basis, the adjustment can be made to subsequently acquired like property.

If there is an **increase** in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their **FMVs.**

If there is a **decrease** in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their **adjusted bases.**

Note. The basis cannot be decreased below zero.

If property cannot be adjusted because the partnership does not have any property that has a character that requires adjustment or all of the property has a zero basis, the adjustment can be made when the partnership acquires property with a like character.

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Example 22. Florencia purchases Glenda's partnership interest for $145,000. The partnership has a §754 election in effect. The partnership balance sheet at the time of the sale follows.

	Adjusted Basis		FMV		Difference	
IRC §§1221 and 1231 property						
Equipment	$ 40,000		$ 60,000		$ 20,000	
Land	100,000		280,000		180,000	
Buildings	95,000		65,000		(30,000)	
	$235,000	$235,000	$405,000	$405,000	$170,000	$170,000
Other property						
Cash	$ 10,000		$ 10,000		$ 0	
Accounts receivable	0		20,000		20,000	
Inventory	40,000		60,000		20,000	
	$ 50,000	50,000	$ 90,000	90,000	$ 40,000	40,000
Total assets		$285,000		$495,000		$210,000
Liabilities and capital						
Liabilities		$ 60,000		$ 60,000		$ 0
Capital: Glenda		75,000		145,000		70,000
Capital: Delmiro		75,000		145,000		70,000
Capital: Crisol		75,000		145,000		70,000
Total liabilities and capital		$285,000		$495,000		$210,000

Florencia paid $145,000 for her share of the partnership. Her outside basis includes her share of the liabilities, for an outside basis of $165,000 ($145,000 + 20,000).

Florencia has an inside basis of $95,000 ($75,000 + $20,000).

Consequently, Florencia must adjust her basis in the partnership by $70,000 (165,000 − $95,000). This is the difference between her inside basis and her outside basis. Although the partnership must make the IRC §743 adjustment, only Florencia benefits from the basis adjustment.

	Difference between FMV and Partnership Basis	Total Adjustment	Amount of Allocation
Step 1: Allocation to the 2 groups			
Capital assets and §1231 property	$170,000	$70,000 × (170 ÷ 210)	$56,667
Other property	40,000	$70,000 × (40 ÷ 210)	13,333
Total	$210,000		$70,000
Step 2: Allocating to individual assets			
Equipment	$ 20,000	$56,667 × (20 ÷ 200)	$ 5,667
Land	180,000	$56,667 × (180 ÷ 200)	51,000
Total	$200,000		$56,667
Accounts receivable	$ 20,000	$13,333 × (20 ÷ 40)	$ 6,667
Inventory	20,000	$13,333 × (20 ÷ 40)	6,666
Total	$ 40,000		$13,333
Total allocation			$70,000

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Florencia will increase her basis by:

- $5,667 in equipment,
- $51,000 in land,
- $6,667 in accounts receivable, and
- $6,666 in inventory.

No allocation was made to the buildings because the FMV did not exceed the adjusted basis. For purposes of depreciation, gain or loss, and dispositions, Florencia has a special basis adjustment for the above properties. **Any special depreciation allocations are reported on Florencia's Schedule K-1.**

MAKING THE §754 ELECTION

To make the IRC §754 election, a written statement must be filed with a timely filed partnership return, including extensions, for the year in which the transfer occurs.[50] Once the election is made, it is continuous and applies to all transfers until it is revoked with the approval of the IRS or the partnership terminates.[51] The statement must include the following information.

- The name and address of the partnership making the election
- Signature of any one of the partners
- Written declaration that the partnership elects under IRC §754 to apply the provisions of IRC §734(b) and IRC 743(b)[52]

If a partnership interest is transferred and a §754 election is made, the §743 adjustment is made **only for the acquiring partner.** There are no adjustments made on the partnership books. Adjustments are only made on the acquiring partner's books. The partnership must attach a reconciliation of depreciation or gain on a sale of assets to the Schedule K-1.

Making the §732(d) Election

If a §754 election is not made, there may be a way to salvage the **adjustment** through a distribution of property, other than money, **within two years of the date the partner's interest was acquired.[53]** The distributed property's adjusted partnership basis, upon the partner's §732(d) election, is the adjusted basis it would have if the §743(b) adjustment was in effect.[54] A §732(d) election is made by the partner, not the partnership, and allows the partner to adjust the basis of the property received from the partnership.

If a §754 election was made in a prior or current year and the partnership terminates due to a technical termination, the new partner must make the basis adjustments for their share of the partnership assets prior to the distribution of the old partnership property.[55] These special adjustments are utilized to distribute the basis of the new partner's interest to the assets distributed to them that are then contributed back into a new partnership.

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50. Treas. Reg. §1.754-1(b)(1). See Treas. Reg. §301.9100-2(a)(2)(vi) regarding an automatic 12-month extension for certain late elections.
51. Treas. Reg. §§1.754-1(b)(1) and 1.754-1(c)(1).
52. IRC §734(b) applies to an unusual basis adjustment to partnership property when gain or loss was recognized on a distribution of property other than money to a partner.
53. IRC §732(d).
54. See Treas. Reg. §1.732-1(d)(vi) for an example.
55. Treas. Reg. §1.708-1(b)(5).

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2011 Workbook

Revoking the §754 Election

Once an IRC §754 election has been made, it is effective until it is revoked. Revocation is only possible with IRS approval. The application to revoke the election must be made no later than 30 days after the close of the taxable year for which the revocation is intended to take effect, and must be signed by one of the partners. Consideration should be given to revoking a §754 election if there has been, for example, a change in the character of the partnership business, a substantial increase in the assets of the partnership, a change in the character of the partnership assets, or an increased frequency in the transactions by partners (i.e., sales or retirements) that might cause administrative burdens. A partnership cannot revoke the election if the purpose of the revocation is to prevent the partnership from reducing its adjusted basis in partnership property.[56]

PARTNERSHIP DISTRIBUTIONS

Normally, when a partner receives cash or property in complete liquidation of their partnership interest, no adjustment is made to the remaining assets within the partnership. However, this may create undesirable consequences to the remaining partners when assets are sold within the partnership.

Example 23. Keenan is a partner of a partnership that makes and sells Native American crafts. The balance sheet of the partnership follows.

	Adjusted Basis	FMV
Assets		
Cash	$10,000	$10,000
Equipment	5,000	20,000
Total assets	$15,000	$30,000
Capital		
Keenan	$ 5,000	$10,000
Conley	5,000	10,000
Tamaya	5,000	10,000
Total capital	$15,000	$30,000

Keenan retires from the partnership and receives $10,000 cash as a complete liquidation payment. Keenan's inside and outside basis is identical. Because the payment exceeds his capital account, Keenan recognizes income of $5,000 ($10,000 − $5,000).

Following Keenan's withdrawal, the remaining partners sell the equipment for $20,000. The partnership recognizes a gain of $15,000 ($20,000 − $5,000). Therefore, Conley and Tamaya each report ordinary income of $7,500 on their individual returns. They report taxable income of $7,500 and Keenan only reports $5,000. Effectively, Keenan's share of the gain on the sale of the equipment is taxed twice. It is taxed once to Keenan on his cash distribution and again to Conley and Tamaya as pass-through income on its sale.

If the two remaining partners take immediate cash distributions and liquidate their partnership interests, they each recognize a capital loss of $2,500 ($5,000 + $7,500 − $10,000) which will offset their distributive share of the gain from the sale of the equipment. However, if they do not dissolve the partnership until the next year, they will have a capital loss to recognize at that time. If their losses exceed their capital gains by more than $3,000, they will be subject to the capital loss rules.

The adverse tax consequences seen in **Example 23** can be avoided by filing a §754 election.

56. Treas. Reg. §1.754-1(c).

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A cash distribution from a partnership is easy to understand. If the amount of the distribution is less than or equal to the partner's capital account, no gain is recognized. The partner's basis is reduced by the amount of the distribution. However, if the amount of the distribution is greater than the partner's basis, the excess distribution is recognized as a capital gain to the partner. The gain can be short- or long-term, depending on the length of time the partner held the interest.

When property other than cash is distributed, the result is more difficult to understand. In order to determine the basis of the property once it is received by the partner, the basis and FMV of the property while it was held by the partnership must be known.

The basis of the asset distributed to the partner in a nonliquidating distribution equals the adjusted basis of the asset in the partnership. It may also not exceed the outside basis in the partner's interest after the reduction for cash and marketable securities.

If the adjusted basis of a partner's interest cannot be determined from the partnership records, an **alternative rule** may be used. This is done by determining the partner's share of the adjusted basis of the partnership property that would be distributed upon the partnership's termination.[57] When the alternative rule is used, adjustments may be necessary to reflect any significant discrepancies arising as a result of contributed property, transfers of partnership property, or distributions of property to partners.

Example 24. Dick, Jane, and Marty are equal partners in the Three Doctors Partnership. The partnership owns numerous properties that have a total adjusted basis of $300,000. During the course of the partnership, the partnership earned and retained $75,000 of cash. This gives the partnership a total adjusted basis of $375,000. Under the alternative rule, each partner's basis is one-third of the total, or $125,000.

Example 25. Marty, from **Example 24,** sells his interest to Michele for $400,000. The sale occurs when the partnership property has an adjusted basis of $450,000 and an FMV of $1.2 million. Michele's basis in her partnership interest is $400,000. However, her adjusted basis in the partnership property is $150,000 ($450,000 ÷ 3). Under the alternative rule, Michele has an adjustment of $250,000 to the basis of her interest. This is the difference between the purchase price, $400,000, and her share of the basis at the time of purchase of $150,000.

Example 26. A year later, Michele from **Example 25** decides to sell her partnership interest. While she owned the interest, her share of the profits was $2,000 and she received a $500 cash distribution. The adjusted basis of the assets in the partnership is $525,000. Michele must determine the adjusted basis of her interest. She cannot use the general rule, but must use the alternative rule.

Michele's share of the basis of the partnership assets is $175,000 ($525,000 ÷ 3). She must make an adjustment of $250,000 to reflect the amount she paid Marty in excess of his capital account. Her adjusted basis for purposes of the sale is $425,000 ($175,000 + 250,000).

If both property and cash are distributed to a partner, the cash reduces basis first.

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57. Treas. Reg. §1.705-1(b).

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IDENTIFYING A DISPROPORTIONATE DISTRIBUTION[58]

To determine if a pro rata share of partnership property was distributed, the FMV of all the partnership assets is considered, rather than the bases in these assets. In order to fall within the regular pro rata distribution rules, each partner's share of IRC §751 assets and other property (including cash) must remain unchanged after the distribution. When the partner's share of the partnership's IRC §751 and non-IRC §751 assets is altered, IRC §751(b) rules apply.

Note. When a partner receives debt relief (and nothing else) from the partnership in a liquidating distribution, the partner is considered to have received a cash distribution. If there are any IRC §751 assets, including depreciation recapture, then there would be a disproportionate distribution.

Conceptual Overview

Treas. Reg. §1.751-1 divides the distribution into two parts.

1. The non-pro rata portion of the distribution is carved out and treated as a taxable sale. This is referred to as a "deemed distribution" or a "deemed exchange." Both the deemed distribution and the deemed exchange have all of the tax consequences of a true distribution and sale. The regular sale and exchange Code sections apply to this portion of the transaction, including IRC §§1231, 1001(b) and (c), and 1011.
2. The remaining pro rata portion of the distribution follows the regular distribution rules.

The purpose of treating a portion of the distribution as a sale or exchange is to prevent the partners from converting ordinary income into capital gain. It ensures that after a distribution, each partner eventually reports their share of ordinary income from the IRC §751 property that was held in the partnership immediately before the distribution.

The IRC §751(b) regulations provide the mechanism for handling the portion of the distribution subject to the sale or exchange treatment. Under these regulations, the following is deemed to occur.

1. If the distributee partner receives **more than** their share of IRC §751 property, they are deemed to have swapped their share of non-IRC §751 property for IRC §751 property in a fully taxable exchange.
2. If the distributee partner receives **less than** their share of the IRC §751 property, then they are deemed to have swapped their share of IRC §751 property for non-IRC §751 property in a fully taxable exchange.

Unrealized receivables are **always** considered IRC §751 property, but in a disproportionate distribution, inventory must meet the "substantially appreciated" test in IRC §751(b)(3) to be considered IRC §751 property.

Distributee Partner Receives More Than Their Share of IRC §751 Property

Partner Consequences. The distributee partner is deemed to have sold or exchanged their share of non-IRC §751 property, including cash as follows.

1. The distributee recognizes gain or loss equal to the difference between the adjusted basis in the non-IRC §751 property surrendered and the FMV of the IRC §751 property deemed to have been purchased.
2. The distributee partner's adjusted basis in the non-IRC §751 property surrendered is the basis that the property would have if they had received it in a current distribution under the regular distribution rules of IRC §§731 through 735.
3. This will generally result in a taxable capital gain or loss to the distributee partner. The character of the gain or loss recognized by the distributee partner is determined by the non-IRC §751 property surrendered.

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58. IRS *Partnership Audit Technique Guide,* Chapter 4 Distribution (LMSB-04-1107-076, revised Dec. 2007).

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Partnership Consequences.

1. The partnership recognizes a gain or loss determined by the difference between the partnership's adjusted basis in the IRC §751 property surrendered in the deemed exchange and the FMV of the non-IRC §751 property deemed purchased.
2. The FMV of the non-IRC §751 property deemed to be purchased is the distributee partner's FMV interest in the IRC §751 property surrendered.
3. Because the character of the gain or loss by the partnership is determined with respect to the IRC §751 property surrendered, the character of the gain or loss will be ordinary. Under IRC §702(a)(7), this ordinary income recognized by the partnership is reported as a separately stated item to all partners other than the distributee partner.

Distributee Partner Receives Less Than Their Share of IRC §751 Property

In this situation, the distributee partner is deemed to have sold their share of IRC §751 property.

Partner Consequences.

1. The distributee partner recognizes gain or loss equal to the difference between the adjusted basis in the IRC §751 property surrendered in the deemed exchange and the FMV of the non-IRC §751 property deemed to be received.
2. The distributee partner's adjusted basis in the IRC §751 property surrendered is the basis that the property would have in a current distribution under the regular distribution rules of IRC §§ 731 through 735.
3. The FMV of the non-IRC §751 property received is the distributee partner's FMV interest in the IRC §751 property surrendered.
4. The character of the distributee partner's gain or loss is determined by the IRC §751 property surrendered, which means that there will always be taxable ordinary income to the distributee partner.

Partnership Consequences.

1. The partnership recognizes a gain or loss determined by the difference between the partnership's adjusted basis in the non-IRC §751 property surrendered in the deemed exchange and the FMV of the IRC §751 property deemed purchased.
2. The FMV of the IRC §751 property deemed purchased is the distributee partner's FMV interest in the non-IRC §751 property surrendered.
3. The character of the gain or loss by the partnership is determined by the non-IRC §751 property surrendered. Generally, this is capital gain. Under IRC §702(a)(7), the capital gain the partnership recognizes is reported as a separately stated item to all of the partners, other than the distributee partner.

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Example 27. CNN Partnership has substantially appreciated inventory of $30,000 with an income tax basis to the partnership of $6,000. It has capital assets of $90,000 with an income tax basis to the partnership of $50,000. Torrance wishes to reduce his partnership interest from half to a third through a distribution of capital assets. The partnership transfers $30,000 of capital assets to Torrance and reduces his partnership capital account from $60,000 to $30,000 and his partnership interest from half to a third.

	FMV	Basis
Inventory	$30,000	$ 6,000
Capital asset	90,000	50,000

	Partnership Total		Torrance					
	FMV Before	FMV After	½ FMV Before	⅓ FMV After	Change in Torrance's Share	Torrance Received	Excess Share	Relinquished
Inventory	$ 30,000	$30,000	$15,000	$10,000	($ 5,000)	$ 0	$ 0	$5,000
Capital assets	90,000	60,000	45,000	20,000	(25,000)	30,000	5,000	0
Total	$120,000	$90,000	$60,000	$30,000	($30,000)	$30,000	$5,000	$5,000

Torrance's inventory basis is calculated as follows.

$$\frac{\textbf{Inventory Relinquished}}{\textbf{Total Inventory}} \times \textbf{Inventory Basis} = \frac{\$5{,}000}{\$30{,}000} \times \$6{,}000 = \$1{,}000$$

Torrance's deemed gain on relinquished property	
Deemed sale	$ 5,000
Basis	1,000
Deemed gain	$ 4,000
Partnership inventory basis	
Before transfer	$ 6,000
Basis transferred	(1,000)
Deemed sale	5,000
New basis	$10,000
Partnership return	
Deemed sale	$ 5,000
Basis: ($50,000 ÷ $90,000) × $5,000	2,778
Partnership gain	$ 2,222
Increase to basis of partnership assets	$ 2,222

Note. The partnership received this step up in basis on inventory due to the gain recognized by Torrance. It was not due to a §754 election. In fact, such an election does not need to be in place to receive this type of step up.

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Torrance is deemed to have sold his $5,000 share of inventory relinquished to the partnership for $5,000.[59] His proportionate basis in the relinquished inventory is $1,000.

$$\frac{\$5,000}{\$30,000} \times \$6,000 = \$1,000$$

He has reportable ordinary income of $4,000 ($5,000 – $1,000 basis). The partnership has an increase in the basis of inventory of $4,000 ($5,000 deemed sale – $1,000 basis on amount deemed sold). There is no adjustment to capital assets for Torrance because the assets were distributed to Torrance and removed from the partnership books.

The partnership is deemed to have sold $5,000 of capital assets to Torrance. The partnership's basis in the assets sold is:

$$\frac{\$50,000}{\$90,000} \times \$5,000 \text{ sale} = 0.555 \times \$5,000 = \$2,778$$

The partnership gain is $2,222 ($5,000 – $2,778). The gain is added to the basis of the remaining partnership capital assets and reported as taxable gain by the other partners.

PROPORTIONATE DISTRIBUTION OF ALL ASSETS

For distributions of partnership assets after August 5, 1997, the procedure for allocating the remaining basis after allocations of cash is described here.[60]

Generally, the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership immediately before the distribution.[61] However, the basis to the partner receiving the property may not exceed the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.[62]

The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.[63]

The basis of distributed properties is allocated in the following order.

1. It is allocated to any unrealized receivables[64] and inventory items[65] in an amount equal to the adjusted basis of each such property to the partnership.[66] If the partner's basis is less than the sum of the adjusted bases of the properties in the partnership, then, to the extent any decrease is required in order to have the adjusted bases of the properties equal the partner's basis, the bases are allocated in the manner described below.[67]
2. If the partner has remaining basis, the basis is allocated to each additional distributed asset in an amount equal to the basis of the asset in the partnership.[68] If any increase or decrease in basis is required for the properties to have a basis equal to the remaining partner's basis, the allocation method shown below is used.[69]

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59. IRC §751(b)(1).
60. IRC §732(c).
61. IRC §732(a)(1).
62. IRC §732(a)(2).
63. IRC §732(b).
64. As defined in IRC §751(c).
65. As defined in IRC §751(d).
66. IRC §732(c)(1)(A)(i).
67. IRC §732(c)(1)(A)(ii).
68. IRC §732(c)(1)(B)(i).
69. IRC §732(c)(1)(B)(ii).

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If there is **additional basis** to allocate, it is allocated in the following order.

1. The basis is first allocated to properties with unrealized appreciation in proportion to the properties' respective amounts of unrealized appreciation before the increase in basis (but only to the extent of each property's unrealized appreciation).[70]
2. To the extent the basis increase is not fully allocated, basis is then allocated in proportion to the properties' respective FMVs.[71]

If the basis of the partnership interest after the allocation to cash, inventory, and unrealized receivables is **less than** the basis of the remaining assets, the decrease is allocated in the following order.

1. The basis is allocated to properties with unrealized depreciation in proportion to the properties' respective amounts of unrealized depreciation before the decrease in basis (but only to the extent of each property's unrealized depreciation).[72]
2. To the extent any decrease has not been allocated, the basis is allocated in proportion to the properties' respective adjusted bases.[73]

Example 28. Sue, Marc, and Gary each own a one-third interest in the SMG Partnership. The partnership owns three lots having the following bases and FMVs. The lots are not inventory or unrealized receivables. The partners' outside basis is shown in the following table.

Inventory	Partnership Basis	FMV
Lot 1	$ 30,000	$ 45,000
Lot 2	40,000	50,000
Lot 3	50,000	55,000
Total	$120,000	$150,000
Outside Basis		
Sue	$ 45,000	
Marc	60,000	
Gary	30,000	

Upon liquidation of the partnership, each partner receives an undivided one-third interest in each lot. Their bases in the lots are as follows.

1. Sue's basis in her partnership interest is greater than her one-third interest in the partnership. Therefore, she increases her basis in each lot.

Outside basis	$45,000
Basis of property received	(40,000)
Excess basis	$ 5,000

70. IRC §732(c)(2)(A).

71. IRC §732(c)(2)(B).

72. IRC §732(c)(3)(B).

73. Ibid.

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Property	1 Share of Basis	2 Share of FMV	3 Unrealized Appreciation	4 Percentage of Appreciation[a]	5 Increase	6 Substitute Basis
Lot 1	$10,000	$15,000	$ 5,000	50.00%	$2,500	$12,500
Lot 2	13,333	16,667	3,334	33.34%	1,667	15,000
Lot 3	16,667	18,333	1,666	16.66%	833	17,500
Total	$40,000	$50,000	$10,000	100.00%	$5,000	$45,000

[a] Column 4 is the percentage of each amount in column 3.

2. Marc's basis in his partnership interest is greater than the FMV of the properties he receives. He increases his basis in each lot in proportion to the lot's FMV.

Outside basis	$60,000
Basis of property received	(40,000)
Excess basis	$20,000
Unrealized appreciation	(10,000)
Amount for FMV allocation	$10,000

Property	1 Share of Basis	2 Share of FMV	3 Unrealized Appreciation	4 Percentage of Appreciation[a]	5 Increase	6 Substitute Basis
Lot 1	$10,000	$15,000	$ 5,000	30.00%	$ 3,000	$18,000
Lot 2	13,333	16,667	3,334	33.34%	3,333	20,000
Lot 3	16,667	18,333	1,666	36.66%	3,667	22,000
Total	$40,000	$50,000	$10,000	100.00%	$10,000	$60,000

[a] Column 4 is the percentage of each amount in column 2.

3. Gary's outside basis in his partnership interest is less than the basis of the lots he receives. Therefore, he must reduce the basis in each lot as follows.

Outside basis	$30,000
Basis of property received	(40,000)
Decrease in basis	($10,000)

Property	1 Share of Basis[a]	2 Percentage of Basis	3 Decrease	4 Substitute Basis
Lot 1	$10,000	25.00%	($ 2,500)	$ 7,500
Lot 2	13,333	33.33%	(3,333)	10,000
Lot 3	16,667	41.67%	(4,167)	12,500
Total	$40,000	100.00%	($10,000)	$30,000

[a] Column 2 is the percentage of each amount in column 1.

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ABANDONMENT OF PARTNERSHIP INTERESTS

At some time in the life of a partnership, one or more partners may want to leave the partnership. In some cases, the partner is willing to abandon their partnership interest just for the purpose of getting away from the potential liabilities. This is frequently the case in a family partnership when the younger generation wants to expand and the older generation wants to maintain the status quo.

If the abandonment of a partnership interest results in a loss, an identifiable event must occur in order to claim the deduction.[74] Typically, a letter to the creditors indicates that the partner is no longer liable for notes. While the lender might not release the partner from existing notes, the exiting partner is not liable for any future loans. This letter and a letter to the remaining partners is enough to demonstrate that an identifiable event occurred.

If the abandonment of a partnership interest results in the partner being relieved of debt, the debt relief is treated as a deemed sale. If the partner does not have basis in excess of the deemed sale, they must recognize a gain. This gain is reported on the partner's Form 1040, Schedule D, *Capital Gains and Losses,* as a capital gain. It is reported as a long-term gain if the partnership interest was held for more than one year. The gain is also reported on Form 8949, *Sales and Other Dispositions of Capital Assets.*

[74] Treas. Reg. §1.165-1(b).

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Example 29. Bill is a 40% partner with his daughter and son in Bill's Family Restaurant. The son just graduated from the Mahomet School of Culinary Arts. He wants to use his education and turn the family business into a gourmet restaurant. Bill, on the other hand, does not think the community can support an upscale restaurant. Bill's daughter supports her brother's proposed changes. The son estimates that the cost of conversion, new equipment, and additional promotion will cost $400,000. After studying the restaurant balance sheet, Bill decides to abandon his interest in the partnership as long as he is not responsible for any current or new debt. The balance sheet of the partnership at the time of Bill's abandonment is as follows.

	Adjusted Basis		FMV	
Current assets				
Cash	$ 5,000		$ 5,000	
Inventory	15,000		15,000	
Total current assets	$20,000	$20,000	$ 20,000	$ 20,000
Fixed assets				
Leasehold improvements	$50,000		$195,000	
Furniture and fixtures	15,000		60,000	
Total fixed assets	$65,000	65,000	$255,000	255,000
Total assets		$85,000		$275,000

	Adjusted Basis		FMV	
Current liabilities				
Accounts payable	$ 40,000		$ 40,000	
Operating loan	50,000		50,000	
Total current liabilities	$ 90,000	$ 90,000	$ 90,000	$ 90,000
Fixed liabilities				
Long-term loans	$180,000		$180,000	
Total fixed liabilities	$180,000	180,000	$180,000	180,000
Capital accounts				
Capital account: Bill	($ 74,000)		$ 2,000	
Capital account: son	(55,500)		1,500	
Capital account: daughter	(55,500)		1,500	
Total capital accounts	($185,000)	(185,000)	$ 5,000	5,000
Total liabilities and capital accounts		$ 85,000		$275,000

Bill has $2,000 in equity. After the transfers are complete, the tax preparer tells Bill he must pay income tax on $74,000.

Bill is deemed to have sold his interest for $108,000 for relief from his 40% share of partnership debt. Bill's basis is the total of his capital account plus his share of the debt, or $34,000 (($74,000) + $108,000). Therefore, the gain is $74,000 ($108,000 − $34,000).

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For Example 29

Form 8949 (2011) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.
Bill

Your social security number
123-45-6789

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

Note. Please round and use whole dollars on this form.
Check the box below that describes the transactions listed on this page.
Caution. Check only one box. If you have more than one type of transaction, complete a separate Form 8949 for each type.

☐ **(A)** Long-term gains and losses (Form 1099-B, box 3, shows basis)
☐ **(B)** Long-term gains and losses (Form 1099-B, box 3, does not show basis)
☑ **(C)** Long-term gains and losses (Form 1099-B not received)

3 **(a)** Description of property (Example: 100 sh. XYZ Co.)	**(b)** Code	**(c)** Date acquired (Mo., day, yr.)	**(d)** Date sold (Mo., day, yr.)	**(e)** Sales price (see instructions)	**(f)** Cost or other basis (see instructions)	**(g)** Adjustments to gain or loss
Restaurant Partnership		1/1/2008	1/1/2011	108,000	34,000	
4 Totals. Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, line 8 (if box A above is checked), line 9 (if box B above is checked), or line 10 (if box C above is checked) . . . . ▶			4	108,000	34,000	

Form **8949** (2011)

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For Example 29

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074
2011
Attachment Sequence No. **12**

Name(s) shown on return: **Bill**
Your social security number: **123-45-6789**

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

Note: Please round and use whole dollars on this form.	**(e)** Sales price from Form(s) 8949, line 2, column (e)	**(f)** Cost or other basis from Form(s) 8949, line 2, column (f)	**(g)** Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	**(h) Gain or (loss)** Combine columns (e), (f), and (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I		( )		
2 Short-term totals from all Forms 8949 with box B checked in Part I		( )		
3 Short-term totals from all Forms 8949 with box C checked in Part I		( )		

Line	Description	No.	Amount
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (h)	7	

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

Note: Please round and use whole dollars on this form.	**(e)** Sales price from Form(s) 8949, line 4, column (e)	**(f)** Cost or other basis from Form(s) 8949, line 4, column (f)	**(g)** Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	**(h) Gain or (loss)** Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		( )		
9 Long-term totals from all Forms 8949 with box B checked in Part II		( )		
10 Long-term totals from all Forms 8949 with box C checked in Part II	108,000	(34,000)		74,000

Line	Description	No.	Amount
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (h). Then go to Part III on the back	15	74,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2011**

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CHANGE IN OWNERSHIP INTEREST

A partner may sell all or a portion of their partnership interest during the year. If the sale does not occur on the first or last day of the partnership tax year, the partnership must decide how to allocate income, losses, and deductions on the Schedule K-1. The taxable year of a partnership does not close for any of the following reasons.

- Death of a partner
- Entry of a new partner
- Liquidation of a partner's interest in the partnership
- Sale or exchange of a partner's interest in the partnership unless there is a termination of the partnership[75]

However, the tax year of a partnership closes for a partner whose **entire interest** in the partnership terminates (whether by reason of death, liquidation, or otherwise).[76]

The tax year of the partnership **does not close** for the partner if the partner disposes of **less than their entire interest** (other than at the end of the partnership's tax year).[77] It does not matter whether the change in ownership interest is due to the entry of a new partner, partial liquidation of the partner's interest, gift, or otherwise.

The method of prorating the partnership items of income, gain, loss, deduction, or credit to the partner is flexible. Any method prescribed in the regulations that takes into account the varying interests of the partners can be used.[78] These include any of the following.

1. Assigning the appropriate portion of each item to each day in the period to which it is attributable[79] and allocating the portion assigned to each day among the partners in proportion to their interests at the close of that day (This has the same effect as closing the partnership book on the day of the ownership change.)
2. By prorating the partnership items over the tax year
3. Any other reasonable method

Because the Code is vague, the IRS issued proposed regulations in 2009 in an attempt to clarify how the allocations should be made for the partner whose ownership interest changed. However, these regulations were not finalized.

The proposed regulations explain that if there is a disposition of less than the entire interest, the distributive share is determined by using an interim closing. However, if the partners agree, they may use a proration method. All partners must use the same method.[80]

Interim Closing Method

If the partnership agreement does not contain a specific provision on the allocation, the interim closing method is used. The partnership maintains segments, which are the specific periods of the partnership's tax year. The first segment begins on the first day of the partnership's taxable year and ends at the close of the day specified by the convention upon which the partners agree.[81] Either a calendar day or a semi-monthly convention can be used.[82]

75. IRC §706(c)(1).
76. IRC §706(c)(2)(A).
77. IRC §706(c)(2)(B).
78. IRC §706(d)(1).
79. IRC §706(d)(2)(A)(i).
80. Prop. Treas. Reg. §1.706-4(a)(1).
81. Prop. Treas. Reg. §1.706-4(a)(2).
82. Prop. Treas. Reg. §1.706-4(c)(2).

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Example 30. The Four Buddies Partnership has four partners at the beginning of the year. On February 5, 2010, Partner 1, a 20% partner, sells half of his partnership interest to Partner 5. On July 25, 2010, Partner 2 sells one-fourth of his 60% partnership interest to Partner 6. The ownership and income of the partnership is shown below. Each partner's Schedule K-1 reports the income as follows.

	Jan. 1–Feb. 5 (36 Days)		Feb. 6–Jul. 25 (170 Days)		Jul. 26–Dec. 31 (159 Days)		(365 Days)
	Ownership	**Income**	**Ownership**	**Income**	**Ownership**	**Income**	**Total for K-1**
Partner 1	20%	($ 2,000)	10%	$ 4,000	10%	$ 9,000	$ 11,000
Partner 2	60%	(6,000)	60%	24,000	45%	40,500	58,500
Partner 3	10%	(1,000)	10%	4,000	10%	9,000	12,000
Partner 4	10%	(1,000)	10%	4,000	10%	9,000	12,000
Partner 5	0%	0	10%	4,000	10%	9,000	13,000
Partner 6	0%	0	0%	0	15%	13,500	13,500
Total ownership	100%		100%		100%		
Total income		($10,000)		$40,000		$90,000	$120,000

Proration Method

If the partners agree, they may take into account any variation in a partner's interest in the partnership by allocating the distributive share of partnership items according to their pro rata share of the items for the entire taxable year.

The calendar day convention must be used if the proration method is used for the allocation.

Extraordinary items of the partnership must be allocated among the partners in proportion to their interests at the beginning of the calendar day of the day on which they are taken into account. The extraordinary items are listed in Prop. Treas. Reg. §1.706-4(d)(3).

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Example 31. Using the proration method for the same facts presented in **Example 30,** the Schedule K-1 amounts for each partner are shown below.

	Jan. 1–Feb. 5 (36 Days)		Feb. 6–Jul. 25 (170 Days)		Jul. 26–Dec. 31 (159 Days)		(365 Days)
	Ownership	Income	Ownership	Income	Ownership	Income	Total for K-1
Partner 1	20%	$ 2,367	10%	$ 5,589	10%	$ 5,227	$ 13,183
Partner 2	60%	7,101	60%	33,534	45%	23,524	64,159
Partner 3	10%	1,184	10%	5,589	10%	5,227	12,000
Partner 4	10%	1,184	10%	5,589	10%	5,227	12,000
Partner 5	0%	0	10%	5,589	10%	5,227	10,816
Partner 6	0%	0	0%	0	15%	7,842	7,842
Total ownership	100%		100%		100%		
Total income		$11,836		$55,890		$52,274	$120,000

The difference in the income reported on Schedule K-1 is shown next.

	Interim Closing	Proration Method	Difference
Partner 1	$ 11,000	$ 13,183	$2,183
Partner 2	58,500	64,159	5,659
Partner 3	12,000	12,000	0
Partner 4	12,000	12,000	0
Partner 5	13,000	10,816	(2,184)
Partner 6	13,500	7,842	(5,658)
Total	$120,000	$120,000	$ 0

If the proration method is used, Partners 1 and 2 report more income and Partners 5 and 6 report less income. There is no difference in the reporting for Partners 3 and 4.

While these are only proposed regulations, they give a good indication of what the IRS believes is an appropriate allocation method.

Technical Termination

If there is a change of 50% or more of the partnership interests within a 12-month period, the partnership is automatically terminated and a new partnership formed.[83] This results in the depreciable assets being assigned a new recovery period based on the recovery period available to that class of asset at the time of the termination. For example, if a nonresidential rental property with a 39-year recovery period is in the 32nd year of depreciation at the time of the termination, the remaining basis of the building will begin depreciation using a new 39-year period.

83. IRC §708.

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SELF-EMPLOYMENT ISSUES

Many new businesses are advised to become S corporations because of the self-employment (SE) tax liability imposed on partners. The tax regulations are very specific. If the partnership carries on a trade or business, a general partner must pay SE tax on their share of the income whether the income is distributed to them or not.[84] The regulations are less clear when the partner is a limited partner or the entity is a limited liability company (LLC) taxed as a partnership.

If partners perform services for the partnership, they are generally treated as receiving SE income. There are exceptions for certain types of distributions of rent, gain on the disposition of property, and investment income.

Limited partners' distributive shares of income or loss, other than distributions that are guaranteed payments as compensation for services, are excluded from SE earnings. However, this is only to the extent that those payments are actually remuneration for those services. If the guaranteed payment represents a minimum level of return on capital, then SE tax is not imposed.

LLC TAXED AS A PARTNERSHIP

A member of an LLC is neither a general partner nor a limited partner. The IRS has a difficult time determining the SE status of an LLC member. The IRS issued proposed regulations three times trying to clarify this SE issue.

The first set of proposed regulations (that were never finalized) indicated that if any of the following applied, the member's earnings were not SE income.

- The member lacked the authority to make management decisions to conduct company business.
- The LLC could have been formed as a limited partnership in the same jurisdiction.
- The member could have qualified as a limited partner under applicable law.

In January 1997, a second set of regulations was issued[85] that would have subjected any LLC member's distributive share of earnings to SE tax if they:

- Had authority to enter into contracts on behalf of the partnership,
- Participated in the partnership's trade or business more than 500 hours per year, or
- Had personal liability for the debts or obligations of the partnership by reason of being a partner.

Furthermore, a special rule provides that service partners in professional service partnerships are never treated as limited partners for SE tax purposes. As a result, these "service" LLC members are subject to SE tax whether they receive a guaranteed payment or K-1 distributive income.

The third test under these proposed regulations[86] caused the most controversy because the size of the debt for which the member was liable did not matter. For instance, when a lender required an LLC member to serve as a guarantor of the business's debt, this meant that SE tax would be imposed. This was the case even when a guarantor was not involved with the day-to-day operations of the entity. However, because these regulations were merely proposed, many practitioners simply chose to ignore their guidance, especially for LLC members who only acted as guarantors.

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84. Treas. Reg. §1.1402(a)-1(a)(2).

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

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

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The negative reaction continued to such an extent that Congress finally imposed a moratorium on the implementation of these regulations. Nevertheless, when the moratorium expired without any further action from Congress, a third set of proposed regulations was issued. They were identical to the second set with one major exception: they provided that LLC members could have "varying (multiple) interests" in the underlying entity. This might mean that guaranteed payments would be subject to SE tax, but the members' distributive share of business profits would be considered a return on equity exempt from SE tax. However, members of professional service LLCs are specifically precluded from taking advantage of this exception.

VARYING INTERESTS IN AN LLC

The most recent proposed regulations define an individual who is not a limited partner.[87] If a limited partner has day-to-day management responsibilities for the LLC's business operations, the regulations state that this member may exclude from net earnings, for SE tax purposes, a portion of that individual's distributive share if they hold more than one class of interest in the partnership or LLC.

The **varying interest rule** applies to partners who hold more than one class of interest in the LLC.[88] Briefly stated, the proposed regulations permit an individual who participates in the trade or business of the partnership to bifurcate their distributive share by disregarding guaranteed payments for services. However, bifurcation of interests is permitted only to the extent that the individual's distributive share is identical to the distributive share of partners who qualify as limited partners under the proposed regulations, without regard to the bifurcation rules.

Prop. Treas. Reg. §1402(a)-2(h)(6)(i) defines "class of interest" as an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment made to an individual for services rendered to or on behalf of a partnership is not a factor in determining the rights and obligations of a class of interest. Furthermore, the class of interest must be substantial. Prop. Treas. Reg. §1.1402(a)-2(h)(6)(iv) explains that a **substantial interest** is determined based on all the facts and circumstances. However, in all cases, **ownership of 20% or more** of a specific class is considered substantial.

If an individual is not a limited partner solely because they participate in the entity's trade or business for more than 500 hours, they can still be treated as a limited partner (the holder of one class of interest rule for those that provide more than 500 hours of service).[89] 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 and who own **a substantial, continuing interest in the entity.**[90] 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.[91] For purposes of this exception, professional services include services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[92]

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87. Prop. Treas. Reg. §1.1402(a)-2(h)(2).
88. Prop. Treas. Reg. §1.1402(a)-2(h)(3).
89. Prop. Treas. Reg. §1.1402(a)-2(h)(4).
90. Prop. Treas. Reg. §1.1402(a)-2(h)(4)(i).
91. Prop. Treas. Reg. §1.1402(a)-2(h)(5).
92. Prop. Treas. Reg. §1.1402(a)-2(h)(6)(iii).

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Example 32. Angela, Barbra, and Connie form an LLC to engage in a business that does not provide services. 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 the 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, only Connie has the authority to contract on the LLC's behalf.

In this scenario, Angela is treated as a limited partner in the LLC because she is not personally liable for debts of, or claims against, the LLC.[93] Angela does not have authority to contract for the LLC under state 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.[94]

Barbra's treatment in this scenario is more complex. She must use the varying interest rule to avoid SE tax. Unless she takes advantage of this rule, Barbra is **not** treated as a limited partner. As a result, Barbra's guaranteed payment of $6,000 is included in her net earnings from self-employment under IRC §1402(a)(13).[95] Furthermore, Barbra is **not** treated as a limited partner with respect to other income flowing through to her on her Schedule K-1 because she participates in the LLC's trade or business for more than 500 hours during the taxable year.[96] As such, Barbra's distributive share would also be included in her net earnings from self-employment.

However, by using the **varying interest rule,** Barbra **is** treated as a limited partner. This is because Angela, who is a limited partner under the regulations, owns a **substantial interest** with rights and obligations that are identical to Barbra's rights and obligations.[97] In this example, Barbra's distributive share is deemed a return on her investment in the LLC and not remuneration for any services she renders to the LLC. Therefore, Barbra's distributive share attributable to her two LLC units is 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.[98] In addition, her distributive share attributable to her LLC unit is considered net earnings from self-employment because she is **not** a limited partner. Connie is **not** treated as a limited partner because she has the authority under state 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.[99] Furthermore, Connie is not treated as a limited partner[100] because she does not hold more than one class of interest in the LLC. Consequently, both Connie's guaranteed payment and distributive share are included in her net earnings from self-employment.

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 (much like the K-1 distributions to the S corporation owner, especially when reasonable compensation is not an issue).

93. Prop. Treas. Reg. §1.1402(a)-2(h)(2).
94. Prop. Treas. Reg. §1.1402(a)-2(i), Example(ii).
95. Prop. Treas. Reg. §1.1402(a)-2(i), Example (iii).
96. Prop. Treas. Reg. §1.1402(a)-2(h)(2).
97. Prop. Treas. Reg. §1.1402(a)-2(h)(4).
98. IRC §1402(a).
99. Prop. Treas. Reg. §1.1402(a)-2(h)(2).
100. Prop. Treas. Reg. §1.1402(a)-2(h)(3).

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Effective Dates

The proposed regulations were **never** 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.[101] There were two bills introduced in 2002 to modernize the Code to explicitly deal with LLC members. However, neither of these was enacted. As of 2011, the IRS has not taken any further action on this matter.

> **Note.** LLC operating agreements should be reviewed and possibly modified to take advantage of the 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 that do not provide services.

The following is from a Joint Committee on Taxation Report for 2001:[102]

> *The Joint Committee staff recommends that references in the Code to "general partners" and "limited partners" should be modernized consistent with the purpose of the reference. In most cases, the reference to limited partners could be updated by substituting a reference to a person whose participation in the management or business activity of the entity is limited under applicable state law (or, in the case of general partners, not limited). In a few cases, the reference to limited partners could be retained because the provisions also refer to a person (other than a limited partner) who does not actively participate in the management of the enterprise, which can encompass limited liability company owners with interests similar to limited partnership interests. In one case, the reference to a general partner can be updated by referring to a person with income from the partnership from his or her own personal services. The recommendation would provide simplification by modernizing these references to accommodate limited liability companies, whose owners generally are partners within the meaning of federal tax law, but are not either general partners or limited partners under state law.*

> **Note.** In the June 3, 1996, market segment specialization program training guide for passive activity losses, IRS auditors are told to examine LLC agreements. If these agreements indicate certain members are essentially limited partners, it is an indicator that they are essentially limited partners for SE tax purposes. If this is not the case, an S corporation should be considered.

The member of a single-member LLC is subject to SE tax in the same manner as a sole proprietor.[103]

> **Observation.** Lawyers drafting operating agreements for LLCs have recently revised these documents to provide for **varying interests** in the entity. Some call them **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 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 a general partnership interest subject to SE tax and receive guaranteed payments subject to SE tax, and hold a limited partnership interest, which is excluded from SE income.

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101. §734 of the Senate amendment to H.R. 2014.

102. Joint Committee on Taxation report JCX-27-01, *Executive Summary of the Federal Tax System and Recommendation for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986.*

103. *Edwards v. Comm'r,* TC Memo 2008-24 (Feb. 7, 2008).

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