Chapter 4: Partnership

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Corrections were made to this workbook through January of 2014. No subsequent modifications were made.

Partnerships are an increasingly common form of business organization, yet the federal income tax rules governing them — set out in Subchapter K of the Code and the Treasury regulations promulgated thereunder — are exceedingly complex. The focus in this chapter is on a few of the most important provisions governing partnership interests, disguised sales, distributions, and guaranteed payments.

PARTNERSHIP INTEREST FOR PERFORMANCE OF SERVICES

The general rule under IRC §721 for contributions of cash or unencumbered property to a partnership, whether newly created or already in existence, is that no gain or loss is recognized to the contributing partner, the transferee partnership, or the noncontributing partners in the partnership. The contributing partner receives an exchanged basis in the partnership interest (referred to as the partner's "outside basis") equal to the basis of the contributed property, essentially deferring the precontribution gain or loss until a later date.[1] The transferee partnership receives a transferred basis in the property (referred to as the partnership's "inside basis") equal to the basis in the hands of the transferor, deferring any gain allocable to the partners until disposition (or over time via depreciation).[2]

The §721 nonrecognition provision is not applicable with respect to the transfer of a partnership interest to a partner for the contribution of services to the partnership, because services are not property. The interest transferred to a service partner may be a **capital interest** or a **profits interest,** each of which has differing consequences.

CAPITAL INTEREST FOR SERVICES

A capital interest entitles a partner to a share of the assets of the partnership upon liquidation, net of any partnership liabilities.[3] Rules for the treatment of the receipt of capital interests for services have been fairly well settled for both the service provider and the partnership.

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1. IRC §722.
2. IRC §723.
3. See, for example, Rev. Proc. 93-27, 1993-24 IRB 6, which defines a capital interest as one that "would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership."

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Capital Interest for Past Services

The receipt of a capital interest for past services is taxable immediately to the partner as compensation, resulting in inclusion of the fair market value (FMV) of the interest at ordinary income rates. The service partner therefore has a "tax cost" basis in the partnership interest of the amount recognized as compensation income. If the service partner is already a partner in the firm, this new basis merely adds to the old basis.

The partnership is treated as if it transferred an undivided tenants-in-common interest in its property to the service partner in return for the services, resulting in a taxable exchange that causes the partnership to recognize gain or loss on the portion of property used to make the compensation payment. That gain or loss is allocated to the nonservice partners, who have used their share of appreciated/depreciated property to pay for the services. The partnership may either deduct the compensation as an expense or treat it as a capitalized cost, depending on the nature of the services performed under general tax principles. That deduction is allocated to the same partners who are treated as shifting some of their capital interest to the service partner.

Note. Proposed regulations issued in 2005, if finalized, will treat the compensation differently on the books of the partnership.

Note. General tax principles determine whether a cost is a deductible expense or a capitalized expenditure. Legal services to organize a partnership are generally treated as specified in IRC §709 (with a maximum of $5,000 deductible upon the commencement of business and the rest amortizable over 180 months), while many costs, such as construction management for a partnership factory building, must be charged to the basis of the building and depreciated over its useful life.

These transactions can be understood conceptually to involve two simultaneous transactions:

1. A compensation payment/receipt transaction and a property disposition/acquisition transaction, followed by
2. A recontribution of the acquired property to the partnership in exchange for the partnership interest.[4]

It is as though the partnership transferred an undivided interest in its assets to the service partner. That transfer is a taxable disposition to the partnership, and the tax gain must be included in the income of the other partners and reflected in the bases of their partnership interests. It is also a payment of compensation to the partner, so the partnership deducts (or capitalizes) the cost (with the deduction also allocable to the nonservice partners). The service partner includes the value in income as compensation and acquires a tax cost basis in the partnership assets. The service partner then recontributes the assets to the partnership in exchange for the partnership interest, giving a tax cost basis in the partnership interest equal to the amount included in income. The partnership now holds the same assets, but with an increased basis from the "recontributed" portion due to the service partner's cost basis. This step up (or step down, if the partnership property was held at a loss) is likely attributable to the service partner under §704(c) principles.

4. See, for example, *McDougal v. Comm'r,* 62 TC 720 (Aug. 29, 1974), which made a determination about a partnership formed after the initial owner of a race horse made a deal with the trainer to give the trainer a half interest in the horse in exchange for services. This case would still apply even after the proposed regulations are finalized to such pre-partnership exchanges of property for services with a later contribution of the property to a partnership.

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Example 1. The DE Partnership, formed recently by the cash contributions of Dwight and Erica, has purchased real estate. The partnership has the following balance sheet at the time that service partner Farrah is invited to join the partnership as an equal partner in return for her services as a real estate marketing expert.

Partnership Assets	Basis	Book
Real estate	$120	$150
Total assets	$120	$150
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Dwight	60	75
Partner Erica	60	75
Total liabilities and equity	$120	$150

Farrah receives compensation income in the form of a partnership interest worth $50 ($150 ÷ 3), the value of which Farrah includes in income, giving her a $50 cost basis in the partnership interest. The partnership has a corresponding deduction (assuming capitalization is not necessary) of $50, allocable equally to Dwight and Erica as the existing partners whose indirect interests in partnership property were used to pay compensation. The partnership also has a tax gain of $10 (($150 ÷ 3) – ($120 ÷ 3)) on the disposition of one-third of the partnership real estate to Farrah to pay her compensation, similarly allocable equally to Dwight and Erica. The resulting balance sheet follows.

Partnership Assets	Basis	Book
Real estate	$130	$150
Total assets	$130	$150
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Dwight	40	50
Partner Erica	40	50
Partner Farrah	50	50
Total liabilities and equity	$130	$150

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Capital Interest for Future Services

If a partner receives a capital interest conditioned on the promise of future services, the rules applicable under IRC §83 for transfers of restricted interests in property are generally considered applicable to the transfer, even without the explicit provision in the proposed regulations. The service provider may wait until completion of the services to include the value in income (at ordinary rates). The service provider is not treated as a partner for tax purposes until the interest vests.[5] Consequently, the service provider is treated as an employee or independent contractor, so that any distributions from the partnership are treated as additional compensation income, the payments are deductible (or capitalizable) to the partnership under general tax principles, and the special rules applying to payments to partners under IRC §707 should not apply.

Alternatively, the service provider may make an election under IRC §83 (within 30 days)[6] to recognize the interest as compensation in the year the partnership interest is initially transferred.[7] The partnership interest is valued at the time of the election as though there were no restrictions, and the service provider is treated as a partner at that time. Any additional distributions are treated as distributions to a partner rather than additional compensation to the service provider. Because the value upon the initial transfer may be considerably less than in the future after the services are completed, this election may effectively convert what would otherwise be ordinary compensation income into capital gain. However, if the conditions are not satisfied and the service partner forfeits the interest, they are not allowed a related deduction for the basis in the forfeited interest.[8]

Example 2. Gale is hired as an executive for PF Partners to manage the partnership for three years, in return for an 8% capital interest in the partnership, currently worth $100,000. Gale will forfeit the interest if she does not complete her management contract. The partnership is expected to be worth $300,000 in three years.

Question. May Gale make an election under §83 and, if so, what is the result?

Answer. The interest is subject to a substantial risk of forfeiture. If Gale elects under §83(b), she recognizes the $8,000 current FMV of the interest ($100,000 × 8%) and includes that amount in income at ordinary rates on the tax return for the year the interest is granted. The risk of forfeiture cannot be considered to discount the value of the interest. If Gale does not complete the contract, she cannot take a deduction to offset the $8,000 income inclusion.

Example 3. Assume the same facts as **Example 2,** except Gale does not make the §83 election because she fears the partnership may decrease in value.

Question. If the partnership appreciates as expected, what is the result?

Answer. Gale must include $24,000 ($300,000 × 8%) in income at ordinary rates with respect to her partnership interest at the end of the three years when the risk of forfeiture is ended.

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5. Treas. Reg. §1.83-1(a)(1).
6. Rev. Proc. 2012-29, 2012-28 IRB 49.
7. IRC §83(b).
8. IRC §83(b)(1).

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PROFITS INTEREST FOR SERVICES

A profits interest generally refers to the right to share in the future income of the partnership. Rules for the treatment of the receipt of profits interests have faced considerable uncertainty and controversy. Private equity funds and hedge funds effectively established a rule that the receipt of an interest in future profits is usually taxable only as those profits are actually realized, and then taxed not as compensation income but rather as characterized by the partnership's assets to which the profits are related. Court cases and interpretative regulations have generally followed that interpretation, finding profits interests taxable upon receipt only if the value is relatively fixed and determinable.[9]

Note. The tax treatment of profits interests is subject to change at any time, especially with the current attention given to the perhaps unfair advantage of capital gains treatment for the "carried interest" paid to managing profits partners in compensation for their management services at private equity funds.[10] Those managers sometimes claim to convert their fees (clearly compensation income) to an equity interest without treating them as compensation paid and then reinvested in the partnership, a claim that is subject to challenge by the IRS.

Under Rev. Proc. 93-27, receipt of a profits interest is not taxable to the new profits partner as long as:

- The partnership does not have a substantially certain income stream,
- The interest is not disposed of within two years of its receipt, and
- The partnership interest is not publicly traded.[11]

The event that causes vesting will also not be a taxable event if the following additional requirements set forth in Rev. Proc. 2001-43 are satisfied.[12]

- The service provider is treated as a partner by the partnership from the date of grant, **and** the partner takes into account their distributive shares of partnership items in computing their income tax liability during the entire period that they hold the interest.
- Neither the partnership **nor** any partners takes a deduction for the value of the interest, either upon grant or when it vests.
- All other conditions in Rev. Proc. 93-27 are satisfied.

Under Rev. Proc. 2001-43, the partnership (i.e., the other partners) does not recognize gain or loss on the indirect transfer of partnership assets in connection with a transfer of a profits interest.

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9. Rev. Proc. 93-27, 1993-24 IRB 6; IRS Notice 2005-43, 2005-24 IRB 1221; *Hale, et. al. v. Comm'r,* 24 TCM 1497 (1965); but see *Diamond v. Comm'r,* 492 F.2d 286 (1974); GCM 36346 (Jul. 25, 1977); *Kenroy v. Comm'r,* 47 TCM 1749 (1984); and *Campbell v. Comm'r,* 943 F.2d 815 (8th Cir. 1991).

10. See, for example, *Types of Income and Business Entities.* Jun. 6, 2013. Senate Finance Committee. [www.finance.senate.gov/imo/media/doc/06062013%20Tax%20Reform%20Options%20Paper_Types%20of%20Income%20and%20Business%20Entities.pdf] Accessed on Jun. 18, 2013. See also Jason A. Zacks, *Note, Effective Taxation of Carried Interest: A Comprehensive Pass-Through Approach,* 89 Wash. U.L. Rev. 449 (2011) (generally supporting treating carried interest as ordinary income from compensation); and Lee Sheppard, *Blackstone Proves Carried Interests Can Be Valued,* 115 Tax Notes 1236 (Jun. 25, 2007) (noting that former Clinton Treasury secretary Robert Rubin supports taxing carried interest at ordinary rates because fund managers are "basically performing a service" and the lower capital gains rate does not contribute to economic growth). Sheppard went on to note that "no one takes seriously any . . . assertion that a carried interest in a valuable investment partnership is worth zero, nor . . . that such interest cannot be valued."

11. Rev. Proc. 93-27, 1993-24 IRB 6.

12. Rev. Proc. 2001-43, 2001-2 CB 191.

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PROPOSED REGULATIONS ON TRANSFERS OF INTERESTS TO SERVICE PARTNERS

Proposed regulations (and the explanatory material in IRS Notice 2005-43) will provide additional guidance if they are finalized.[13] For the service partner, the FMV of a partnership interest transferred for services will be treated as a guaranteed payment.[14] If the partnership interest is vested, the payment will be included immediately. If the partnership interest is not vested, the service provider is not treated as a partner and will not be treated as receiving distributive shares of partnership income or loss unless the service provider makes the §83(b) election. Even if the election is made, there is a potential for forfeiture. Accordingly, allocations of partnership items cannot have economic effect and the partner will generally not recognize allocated items unless:

- The partnership agreement includes a provision for forfeiture allocations to reverse the forfeited allocations among all the partners, and
- Other material allocations under the partnership agreement are respected pursuant to the §704(b) rules.

For the partnership, exchanges of partnership interests for services will not be governed by IRC §721 (as expected); rather, §83 will apply for both profits and capital interests. No gain or loss on the underlying partnership property will be recognized, whether the interest granted is a capital or profits interest. The partnership will treat the transfer as a guaranteed payment for services under IRC §707(c) and will deduct (or capitalize) the value of the transferred interest in the same year that the recipient includes the amount in income. If the interest is forfeited, the partnership would be required to recognize income in a corresponding amount (essentially reversing the deduction).

Note. Taxpayers may rely on a proposed regulation, although they are not required to do so. IRS examiners, however, should follow proposed regulations, unless the proposed regulation is in conflict with an existing final or temporary regulation.

Example 4. Use the same facts as **Example 1** (capital interest for past services), except assume that the proposed regulations have been finalized. The compensation payment of $50 is deducted and allocated to Dwight and Erica, reducing their outside basis and book capital accounts by $25 each. In contrast to current law, the partnership is **not** treated as disposing of an undivided interest in one-third of its property, so there is no tax gain reflected in either the partnership's inside basis or the nonservice partner's outside basis.

Partnership Assets	Basis	Book
Real estate	$120	$150
Total assets	$120	$150
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Dwight	35	50
Partner Erica	35	50
Partner Farrah	50	50
Total liabilities and equity	$120	$150

13. See REG-105346 (May 24, 2005).

14. Valuation of the interest may be determined under one of two methods — a "willing buyer/willing seller" estimate of the FMV that takes into account business prospects, lack of marketability, and other items generally relevant to valuation; or a "safe harbor liquidation value" that determines the cash allocable to the partner upon a constructive liquidation immediately after the transfer. The liquidation value of a profits interest is generally zero.

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DISGUISED SALES

Under the IRC §351(b) corporate tax "boot" requirement, whereby any shareholder/transferor who receives some consideration other than stock ("boot") for items transferred to the corporation immediately recognizes any gain realized on the transfer of contributed property to the extent of boot received on that property. The partnership rules do **not** include an equivalent requirement.

IRC §721 applies only to the transfer of the partnership interest. The partnership provisions treat any other property transferred to the partner concurrently with the contribution transaction as a separate distribution. Thus, the tax consequences of that concurrent transfer to the contributing partner are determined under the various provisions governing partnership distributions and **will not** be governed by §721 **even if:**

- There is a precontribution gain in the contributed property, and
- The contributor receives, in addition to the partnership interest, a cash or property distribution (including a deemed cash distribution from a shifting of debt from the transferor to the other partners).

A distribution and a concurrent contribution are likely to be recast in whole or in part as a sale under the disguised sale rules.[15] If the transfer does not result in the application of the disguised sale rules, any gain from the distribution is treated as recognized on the sale of the partnership interest rather than on the contributed property.

If a partner engages in a transaction with a partnership other than in their capacity as a member of the partnership, the transaction is treated as occurring between the partnership and one who is not a partner. These transactions include sales between a partner and the partnership. Under IRC §707(a)(2)(B), if there is a transfer of money or other property to a partnership and a related transfer of money or other property from the partnership to the partner that, "when viewed together, are properly characterized as a sale or exchange," the transfers are treated as a transaction described in §707(a)(1) — i.e., not as a partnership contribution and distribution but as a sale between unrelated parties, for all federal income tax purposes.

This determination is based on the substance of the transaction, not its form.[16] The intent is to capture as sales a contribution and a related distribution that, when combined, effectively allow a partner to withdraw part or all of their equity in the contributed property from the partnership. Contributions that are actually exchanged for an interest in the partnership and subject to a risk of loss in the enterprise are not intended to be treated as sales. The contribution and distribution of money or other property is treated as a sale **only if,** considering all the facts and circumstances:

- The transfer from the partnership would not have been made but for the transfer of the property; and
- If not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risk of the partnership operations.[17]

Contributions and related distributions that are treated as sales are treated as occurring on the date the partnership becomes the owner of the property under general federal tax principles. If the consideration from the partnership is transferred after the transfer of the property to the partnership, it is treated as a deferred payment sale in which the partnership has an obligation to transfer consideration to the partner as of the date of the property's transfer to the partnership.[18]

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15. IRC §707(a)(2)(b); Treas. Reg. §1.707-3.

16. Treas. Reg. §1.707-1(a); c.f. Treas. Reg. §1.731-1(c)(3) (noting that the regular distribution rule in §731 "does not apply to a distribution of property if, in fact, the distribution is made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner.")

17. Treas. Reg. §1.707-3(b)(1).

18. Treas. Reg. §1.707-3(a)(2).

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The regulations provide the following list of circumstances that may tend to prove a sale.[19]

- There is **reasonable certainty** regarding the timing and amount of the related transfer at the time of the first transfer.
- There is **a legally enforceable right** to the related transfer.
- The partner's **right to consideration is secured.**
- Any person **makes, or is obligated to make,** contributions to the partnership necessary for the partnership to make the related transfer.
- Any person **loans, or agrees to loan,** money to the partnership necessary for the partnership to make the related transfer (taking into account any contingencies related to partnership operations).
- The partnership **incurs or will incur debt** to enable it to make the related transfer (taking into account any guarantees or similar arrangements).
- The **partnership holds considerable liquid assets beyond the working capital needs** of the business that will be available to make the transfer (taking into account income earned on those assets).
- Partnership distributions, allocations, or control are **designed to effect an exchange of the benefits and burdens of ownership** of the property.
- The related transfer to the partner is **disproportionately large** relative to the partner's interest in the partnership's profits.
- The partner has **no obligation to return or repay** the consideration to the partnership (or it is likely due at such a remote time that the present value of the obligation is small in comparison to its amount).

There is a presumption that a contribution and distribution made within two years of each other (without regard to order) constitute a sale (the 2-year presumption). The 2-year presumption can be rebutted only with facts that **clearly establish** that the transfers are not a sale.[20]

> **Note.** Disclosure of a contribution and distribution made within two years of each other **must be made** by the partnership on Form 8275, *Disclosure Statement.*[21]

EXCEPTIONS

Exceptions to the disguised sales rules include distributions that are guaranteed payments for capital, preferred returns, operating cash flow distributions, or reimbursements of preformation expenditures.[22] The critical issue for both guaranteed payments on capital and preferred returns is that they provide a return **on** investment, not a return **of** the partner's investment in the partnership.

A **guaranteed payment** is "determined without regard to partnership income and is for the use of that partner's capital."[23] As long as a payment that is characterized by the partners as a guaranteed payment is determined without regard to the income of the partnership and is "reasonable," it will be presumed to be a guaranteed payment. Accordingly, the 2-year presumption does not apply, unless the facts clearly establish that it is in fact a partial sale.[24]

19. Treas. Reg. §1.707-3(b)(2).
20. Treas. Reg. §1.707-3(c). Transfers made more than two years apart are presumed not to be a sale under Treas. Reg. §1.707-3(d).
21. Treas. Reg. §§1.707-3(c)(2) and 1.707-8.
22. Treas. Reg. §1.707-4.
23. Treas. Reg. §1.707-4(a)(1)(i).
24. Treas. Reg. §1.707-4(a)(1)(ii).

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A **preferred return** is "a preferred distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain."[25] As long as a payment that is characterized as a preferred return is reasonable, it will be presumed to be a preferred return and not a sale. Accordingly, the 2-year presumption does not apply, unless the facts (including the likelihood and expected timing of later distributive shares of partnership income to support the preferred return) clearly establish otherwise.

A guaranteed payment or preferred return is considered reasonable if the transfers are made pursuant to a written agreement, provide for a reasonable amount in return for the use of capital, and the payment is made after the provision is added to the agreement.[26] The amount is reasonable if the sum of the guaranteed payments and preferred returns from the time the right is established through the end of the year is not more than the partner's unreturned capital multiplied by the safe harbor interest rate (150% of the highest applicable federal rate).[27] (The partners have an option to use a weighted average capital balance for the year rather than the unreturned capital.)

Operating cash flow distributions are transfers that:

- Are not presumed to be guaranteed payments for capital;
- Are not reasonable preferred returns;
- Are not characterized as distributions to a partner acting in a capacity other than as a partner under §707(a)(1); and
- Do not exceed the partner's share of the partnership's net cash flow from operations for the year, determined by multiplying the partnership's net cash flow for the year by the partner's interest in the partnership profits for that year (or, if less, for the life of the partnership).[28]

The "net cash flow from operations" is:

- The partnership's taxable income or loss from the ordinary course of business and investment activities; **plus**
- Tax-exempt interest, depreciation, amortization and cost recovery allowances, and any noncash charges deducted in determining taxable income; **minus**
- Principal payments on debt, established contingency reserves for property, capital expenditures not made from reserves (or debt not included in operating cash flow), and any other cash expenditures (including preferred returns) not deducted in determining taxable income or loss.[29]

As in the case of guaranteed payments and preferred returns, the 2-year presumption will not apply unless facts and circumstances establish that an operating cash flow distribution is part of a sale.

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25. Treas. Reg. §1.707-4(a)(2).
26. Treas. Reg. §1.707-4(a)(3)(i).
27. Treas. Reg. §1.707-4(a)(3)(ii).
28. Treas. Reg. §1.707-4(b)(2).
29. Treas. Reg. §1.707-4(b)(2)(A)–(D).

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PART SALE/PART CONTRIBUTION

If a transfer is treated as a disguised sale and the distribution is less than the FMV of the property at the time of the contribution, the transfer is treated as part sale/part contribution. The distribution is the consideration for the sale, and the ratio of the distribution to the FMV is the portion sold. The transferor-partner prorates the basis between the sale and the contribution to determine the amount of gain recognized.

Example 5. Andie transfers a lot with an FMV of $4,000 and an adjusted tax basis of $1,200 to a partnership, and the partnership immediately transfers $3,000 cash to Andie.[30] The distribution is not characterized as a guaranteed payment or a preferred return to Andie. Her share of the partnership's net cash flow for the year is $0.

Question. Is this a disguised sale and, if so, what is the result for Andie and the partnership?

Answer. Because the two transfers are simultaneous and none of the exceptions to the disguised sales rules apply, this is presumed to be a sale. There is nothing to suggest otherwise. Andie is treated as having sold 75% of the property ($3,000 distribution ÷ $4,000 FMV) and uses 75% of the basis (75% × $1,200 = $900). Andie recognizes a gain of $2,100 ($3,000 amount realized − $900 basis). She contributed the remaining portion of the property (FMV of $1,000 and basis of $300). The partnership holds the property with an aggregate basis of $3,300 ($3,000 purchased + $300 contributed).

Example 6. Use the same facts as **Example 5,** except that the transfer from the partnership is only $1,000. Andie's share of the partnership's net cash flow for the year is $1,000, and a proportional distribution is made to each of the other partners at the same time.

Question. Is this a disguised sale?

Answer. The contribution and distribution are presumed **not** to be a disguised sale because of the operating cash flow distribution exception. There are no facts to rebut the presumption.

Andie has a $4,000 increase to her book capital account from her contribution and a $1,000 decrease from the distribution. Her tax basis shows a net increase of $1,200 ($1,200 contributed basis + $1,000 share of profits − $1,000 distribution). The partnership holds the property with a basis of $1,200.

DISTRIBUTIVE SHARES OF PARTNERSHIP ITEMS

The rules that determine a partner's treatment with respect to a partnership's operations follow two approaches: entity theory and aggregate theory. Under **entity theory,** the partnership is a pass-through entity, resulting in distributive shares. Entity theory is relevant for various tax purposes, including the following.

- Most administrative and judicial procedures governed by IRC §§6221–6233
- The partnership information return filing requirement under IRC §6031
- Certain elections, including the IRC §754 election to adjust basis
- The determination of the tax year under IRC §706
- The computation of separately stated items and the partnership's "bottom-line" taxable income under IRC §703

Under **aggregate theory,** the partners each own an undivided interest in each of the partnership assets and receive a share of each of the partnership's items of income, loss, deduction, and credits passed through with their character intact. There is thus a tension between aggregate and entity treatment that recurs throughout the partnership provisions and, in some situations, creates uncertainty about the likely result of partnership transactions.

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30. This example is based on Treas. Reg. §1.707-3(f), Example 1.

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CALCULATING SEPARATELY STATED ITEMS AND PARTNERSHIP TAXABLE INCOME

A key facet of partnership taxation is the determination of the tax consequences to the partners of owning an interest in the partnership. IRC §701 makes clear that the partnership itself is not subject to tax. The partnership determines its taxable income for information reporting purposes under IRC §703. The computations are similar to those of an individual, except for the following items.

1. It must separately state certain items under IRC §702 (listed later in this section).
2. Certain deductions are not taken into account by the partnership in calculating its taxable income because they are considered applicable only to the partners. These include the following.
   - **a.** Personal exemptions (IRC §151)
   - **b.** Foreign taxes deduction (IRC §164(a))
   - **c.** Charitable contribution deduction (IRC §170)
   - **d.** Net operating loss (IRC §172)
   - **e.** Additional itemized deductions (IRC §§211 et seq.)
   - **f.** Depletion allowance (IRC §611)

Although most of these disallowed deductions for the computation of the partnership's taxable income make sense because they are particular to individuals (e.g., the personal exemption), it should be noted that a partnership may in fact have an expense item related to some of these deductions (e.g., if the partnership has made a charitable contribution). Such items are passed through to the partners as separately stated items; however, like tax-exempt interest, they are not calculated in determining the partnership's taxable income.

On the partner's own income tax return, the partner separately takes into account their "distributive share" of various partnership items, as reported to the partner on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.* The partner receives a distributive share of various "separately stated" partnership items as set forth in IRC §702(a)(1)–(7) and the associated regulations. These are tax items that could potentially have differing impacts on a partner's tax liability, depending on the partner's particular tax attributes (e.g., residency, other sources and character of gains and losses, availability of foreign tax credits, rate bracket, and net operating losses).

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Following are the items that **must be separately stated,** as set forth in IRC §702(a) and Treas. Reg. §1.702-1(a).

1. Gain or loss from sales/exchanges of short-term capital assets
2. Gain or loss from sales/exchanges of long-term capital assets
3. Gain or loss from §1231 property
4. Charitable contributions
5. Qualifying dividends under IRC §1(h)(11)
6. Creditable foreign taxes
7. Other items per the regulatory authority
    a. IRC §103 tax-exempt interest
    b. IRC §165(d) wagering gains or losses
    c. IRC §111 tax benefit amounts
    d. IRC §175 soil and water conservation expenditures
    e. IRC §212 nonbusiness expenses
    f. IRC §213 medical expenses
    g. IRC §214 dependent care expenses
    h. IRC §215 alimony
    i. IRC §216 cooperative housing taxes and interest
    j. IRC §263(c) intangible drilling and development costs
    k. IRC §617 mining exploration expenditures
    l. IRC §751(b) gain or loss to partnership
    m. Any items subject to a special allocation provision under the partnership agreement
    n. Any item that, if taken into account separately, would result in an income tax liability different from the result if not taken into account separately (such as subpart F income or IRC §183 hobby activity items)
    o. Any other item that may be subject to special treatment, such as the IRC §199 deduction; alternative minimum tax preferences; passive activity losses; special allocations under §704(b) and (c); Rev. Rul. 92-97 cancellation of debt income; and investment interest expense

Note. The determining factor for the separate statement of a partnership item is that **any** item that could have a varying tax effect from one partner to another must be separately stated on the Schedule K-1. This includes items that might be subject to special allocations or those that may face different limitations because of the partners' personal attributes, such as passive activity losses, alternative minimum tax preferences, cancellation of debt income, or investment interest expense.

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The Schedule K-1 also reports a partner's distributive share of the residual taxable income determined without including those separately stated items (typically called the partnership's "bottom-line" taxable income). **Bottom-line taxable income under §702(a)(8)** (ordinary business income reported on Schedule K, line 1), bears little resemblance to the taxable income reported on an individual's tax return. It consists of whatever items of income, deductions, gains, losses, and credits are left over after the partnership separates out the items required to be separately stated but does not include any items that are not used in computing partnership taxable income under §703.

Example 7. AB Partnership has the following items that must be reported appropriately on its Form 1065 and the Schedules K-1 for the two partners, Althea and Bronson.

Income	
Gross receipts	$140,000
Qualified dividend income	4,000
Net short-term capital gain	2,000
Net long-term capital gain	6,000
Tax-exempt interest income	1,000
Expenses	
Cost of goods sold	20,000
Salary expense	20,000
Depreciation	16,000
Investment interest expense	4,000
Charitable contributions	1,000
Distributions of cash	
Althea	10,000
Bronson	10,000

The partnership's separately stated items, bottom-line taxable income, and taxable income (TI) are as follows.

	Separately Stated Items	Bottom Line TI Calculations
Gross receipts		$140,000
Cost of goods sold		(20,000)
Salary		(20,000)
Depreciation		(16,000)
Bottom line taxable income under §702(a)(8) (ordinary business income)		$ 84,000
Investment interest expense	($4,000)	
Dividend income	4,000	
Net short-term capital gain	2,000	
Net long-term capital gain	6,000	
§702(a)(1)-(7) separately stated items	$8,000	8,000
Partnership taxable income (§703)		$ 92,000
Items not included in TI but reported to partners		
Tax-exempt interest income	1,000	
Charitable contribution	(1,000)	

AB Partnership's Form 1065, *U.S. Return of Partnership Income,* and Althea's Schedule K-1 follow.

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For Example 7

Form **1065** Department of the Treasury Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2012, or tax year beginning ________, 2012, ending ________, 20 ____.
▶ Information about Form 1065 and its separate instructions is at *www.irs.gov/form1065*.

OMB No. 1545-0099 — 2012

	Print or type.	
A Principal business activity: Tax preparation	Name of partnership: AB Partnership	D Employer identification number: 11-1111111
B Principal product or service: Services	Number, street, and room or suite no. If a P.O. box, see the instructions.: 21 Towne Street	E Date business started: 01/01/2011
C Business code number: 541213	City or town, state, and ZIP code: Stanley, AR 71000	F Total assets (see the instructions) $

G Check applicable boxes: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return
(6) ☐ Technical termination - also check (1) or (2)

H Check accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ 2

J Check if Schedules C and M-3 are attached ☐

Caution. *Include **only** trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.*

	Line	Description				
Income	1a	Gross receipts or sales	1a	140,000		
	b	Returns and allowances	1b			
	c	Balance. Subtract line 1b from line 1a			1c	140,000
	2	Cost of goods sold (attach Form 1125-A)			2	20,000
	3	Gross profit. Subtract line 2 from line 1c			3	120,000
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4	
	5	Net farm profit (loss) (attach Schedule F (Form 1040))			5	
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6	
	7	Other income (loss) (attach statement)			7	
	8	**Total income (loss).** Combine lines 3 through 7			8	120,000
Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	20,000
	10	Guaranteed payments to partners			10	
	11	Repairs and maintenance			11	
	12	Bad debts			12	
	13	Rent			13	
	14	Taxes and licenses			14	
	15	Interest			15	
	16a	Depreciation (if required, attach Form 4562)	16a	16,000		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c	16,000
	17	Depletion **(Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	
	20	Other deductions (attach statement)			20	
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	36,000
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	84,000

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.

▶ Signature of general partner or limited liability company member manager ▶ Date

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self- employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11390Z Form **1065** (2012)

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For Example 7

Form 1065 (2012) Page **4**

Schedule K		Partners' Distributive Share Items			Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)		1	84,000
	2	Net rental real estate income (loss) (attach Form 8825)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (attach statement)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Guaranteed payments		4	
	5	Interest income		5	
	6	Dividends: a Ordinary dividends		6a	4,000
		b Qualified dividends	6b 4,000		
	7	Royalties		7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))		8	2,000
	9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))		9a	6,000
	b	Collectibles (28%) gain (loss)	9b		
	c	Unrecaptured section 1250 gain (attach statement)	9c		
	10	Net section 1231 gain (loss) (attach Form 4797)		10	
	11	Other income (loss) (see instructions) Type ▶		11	
Deductions	12	Section 179 deduction (attach Form 4562)		12	
	13a	Contributions		13a	1,000
	b	Investment interest expense		13b	4,000
	c	Section 59(e)(2) expenditures: **(1)** Type ▶	**(2)** Amount ▶	13c(2)	
	d	Other deductions (see instructions) Type ▶		13d	
Self-Employment	14a	Net earnings (loss) from self-employment		14a	
	b	Gross farming or fishing income		14b	
	c	Gross nonfarm income		14c	
Credits	15a	Low-income housing credit (section 42(j)(5))		15a	
	b	Low-income housing credit (other)		15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468)		15c	
	d	Other rental real estate credits (see instructions) Type ▶		15d	
	e	Other rental credits (see instructions) Type ▶		15e	
	f	Other credits (see instructions) Type ▶		15f	
Foreign Transactions	16a	Name of country or U.S. possession ▶			
	b	Gross income from all sources		16b	
	c	Gross income sourced at partner level		16c	
		Foreign gross income sourced at partnership level			
	d	Passive category ▶ **e** General category ▶ **f** Other ▶		16f	
		Deductions allocated and apportioned at partner level			
	g	Interest expense ▶ **h** Other ▶		16h	
		Deductions allocated and apportioned at partnership level to foreign source income			
	i	Passive category ▶ **j** General category ▶ **k** Other ▶		16k	
	l	Total foreign taxes (check one): ▶ Paid ☐ Accrued ☐		16l	
	m	Reduction in taxes available for credit (attach statement)		16m	
	n	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment		17a	
	b	Adjusted gain or loss		17b	
	c	Depletion (other than oil and gas)		17c	
	d	Oil, gas, and geothermal properties—gross income		17d	
	e	Oil, gas, and geothermal properties—deductions		17e	
	f	Other AMT items (attach statement)		17f	
Other Information	18a	Tax-exempt interest income		18a	1,000
	b	Other tax-exempt income		18b	
	c	Nondeductible expenses		18c	
	19a	Distributions of cash and marketable securities		19a	20,000
	b	Distributions of other property		19b	
	20a	Investment income		20a	
	b	Investment expenses		20b	
	c	Other items and amounts (attach statement)			

Form **1065** (2012)

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For Example 7

651112

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **2012**

Department of the Treasury
Internal Revenue Service

For calendar year 2012, or tax year beginning ________, 2012 ending ________, 20____

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
11-1111111

B Partnership's name, address, city, state, and ZIP code
AB Partnership
21 Towne Street
Stanley, AR 71000

C IRS Center where partnership filed return
Ogden, UT

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
123-45-6789

F Partner's name, address, city, state, and ZIP code
Althea
15 State St
Stanley, AR 71000

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? (see instructions) **Individual**

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here (see instructions) . . . . ☐

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

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

K Partner's share of liabilities at year end:

Nonrecourse	$
Qualified nonrecourse financing .	$
Recourse	$ 5,000

L Partner's capital account analysis:

Beginning capital account	$ 80,000
Capital contributed during the year	$ 0
Current year increase (decrease) .	$ 46,000
Withdrawals & distributions . . .	$ (10,000)
Ending capital account	$ 116,000

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

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

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

No.	Item	Amount
1	Ordinary business income (loss)	42,000
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4	Guaranteed payments	
5	Interest income	
6a	Ordinary dividends	2,000
6b	Qualified dividends	2,000
7	Royalties	
8	Net short-term capital gain (loss)	1,000
9a	Net long-term capital gain (loss)	3,000
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	
	A	500
	H	2,000
14	Self-employment earnings (loss)	
	A	42,000
15	Credits	
16	Foreign transactions	
17	Alternative minimum tax (AMT) items	
18	Tax-exempt income and nondeductible expenses	
	A	500
19	Distributions	
	A	10,000
20	Other information	

*See attached statement for additional information.

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BASIS MECHANISM RELATING TO DISTRIBUTIVE SHARES AND DISTRIBUTIONS

The partner's distributive shares of partnership items (determined in accordance with the rules set forth in §704 and the regulations, as explained in the discussion that follows) are included in the partner's tax return for the year in which they are allocated, even though the partner may not receive a corresponding actual distribution from the partnership.

Distributions are typically not taxable to a partner when received. The basis adjustment mechanism protects the partner from double taxation of income (or double benefit of losses) when the partner later receives a distribution reflecting that distributive share. Under IRC §705, outside basis is adjusted upward for the following items.

- Contributions (face value of cash, adjusted basis of contributed property, deemed contributions of cash for the assumption of liabilities)
- Distributive shares of income or gain (including tax-exempt income)
- The excess of depletion deductions over the basis of property subject to the depletion allowance

Outside basis is adjusted downward for the following items.

- Distributions (in accordance with IRC §733 for distributions other than in liquidation, by any money received, by the basis **to the partner** of any distributed property, and deemed distributions of cash with respect to liability shifts)
- Distributive shares of deductions or losses (including deductions for depletion that do not exceed the partner's share of the property basis subject to the allowance)
- Expenditures of the partnership that are neither deductible nor chargeable to capital in computing partnership taxable income (such as charitable contributions and the 50% meal expense disallowance)

Note. A partner's book capital accounts are adjusted by mechanisms similar to those that adjust basis, as set forth in Treas. Reg. §1.704-1(b)(2)(iv)(b). Differences reflect the economic versus the tax character of the two accounting systems: Contributions increase capital accounts by FMV and basis by the adjusted basis of contributed property, while distributions decrease capital accounts by FMV and basis by the adjusted basis of distributed property. A partner's share of partnership liabilities is not reflected in book capital accounts but is reflected in outside basis. A partner's outside basis can never be negative, but it is possible for a partner's capital account to be negative (if certain conditions are satisfied).

This basis mechanism of increases for distributive shares and reductions for distributions ensures that distributions do not result in taxable income **unless** the amount of a cash distribution exceeds the partner's basis.[31] Property distributions do not cause a partner to recognize gain (unless it is part of a disguised sale). For nonliquidating distributions, the partner takes the partnership's basis in the property, up to the amount of the partner's outside basis in their partnership interest as reduced by any money received in the same distribution.[32]

31. IRC §731(a).

32. IRC §732(a).

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Example 8. Use the same facts as **Example 7.** The two partners of AB Partnership share equally in all income, gain, deductions, losses, and credits. Althea has an outside basis of $80,000 and Bronson has an outside basis of $50,000.

Question. What are the basis adjustments required for each partner if the partnership makes a distribution of $10,000 cash to each partner at the end of the year?

Answer. Each partner increases their outside basis by their distributive shares of half of the partnership's taxable income exclusive of the separately stated investment interest expense and the tax-exempt interest income. They reduce their basis by the distribution and their distributive share of the nondeductible charitable contribution expenditure. Because there is sufficient basis, the partner then takes the separately stated investment interest expense (the only separately stated loss) into account.[33]

	Althea's Basis	Bronson's Basis
Beginning basis	**$ 80,000**	**$50,000**
Partnership §703 taxable income less the separately stated investment expense	48,000	48,000
Tax-exempt interest	500	500
Distribution of cash	(10,000)	(10,000)
Charitable contribution	(500)	(500)
Investment interest expense (loss)	(2,000)	(2,000)
Ending basis	$116,000	$86,000

Note. Because the partners' book capital accounts reflect the economic arrangement between the partners, it is important that they take these items into account as well. Thus, tax-exempt interest and nondeductible expenditures that are not chargeable to capital (such as charitable contributions and the 50% disallowed portion of meal and entertainment expenses) are also reflected in the partner's book capital account. Even suspended losses are nonetheless deducted from the book capital accounts. (Loss limitations are discussed later in this chapter.)

PARTNERSHIP RULES FOR ALLOCATIONS

Because a partner's tax liability from their participation in a partnership depends on their distributive shares of partnership items, the integrity of the determination of those shares is central to the tax consequences, as well as the economics, of the partnership. The allocations of partnership items among the partners reflected in the partnership agreement are honored as long as they meet **one** of the following conditions.[34]

- They have "substantial economic effect" (SEE).
- They reflect the partner's interest in the partnership.
- They are deemed to be in accord with the partner's interest in the partnership.

If a special allocation does not satisfy one of these requirements, it is reallocated according to the partner's interest in the partnership (PIP). The PIP is defined in the regulations as a facts and circumstances determination reflecting the manner in which the partners have agreed to share the economic benefit or burden of the particular item (which may not correspond to the partners' overall economic arrangement).[35]

33. The order in which these items are taken into account is dictated by regulations and rulings. Losses are limited to the outside basis remaining after the other items are taken into account. See IRC §704(d); Treas. Reg. §1.704-1(d)(2); and Rev. Rul. 66-94.

34. IRC §704(a); Treas. Reg. §1.704-1(b)(1)(i).

35. Treas. Reg. §1.704-1(b)(3).

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The tests in the regulations under IRC §704 deal with the book capital accounts of the partners. The idea is to ensure that allocations have economic consequences and are not designed solely to shift tax consequences between the partners. This requires the following two corollaries.

1. The tax allocations should generally follow book (sometimes described as "tax follows cash").

2. For testing allocations, FMV is generally treated as equal to the book value.

The partnership agreement is interpreted broadly to include the original agreement and any modifications to it (as long as it is made prior to the time for filing the relevant partnership return, not counting extensions), whether oral or written. On any matter about which the agreement is silent, default provisions of local law are considered to constitute a part of the agreement.[36] Side agreements between partners cannot be disregarded in assessing burdens and benefits of allocations. In fact, all agreements between the partners as to the partnership affairs — including puts, options, guarantees, and side agreements between two or more of the partners — are part of the partnership agreement for these purposes.[37] If the agreement merely provides for the allocation of income and loss, that provision will be the presumed basis for allocations of all special items as well as bottom-line partnership taxable income or loss.

The SEE test consists of two parts performed annually at the end of the tax year.[38] **Allocations have SEE if:**

1. They have **economic effect** and

2. Are **substantial.**[39]

Economic Effect

Economic effect is an objective test that looks at the way the allocation provisions are stated and the provisions in the partnership agreement. Allocations have economic effect if they satisfy one of three tests: the primary test, an alternate test, or a "lucking out" economic equivalence test (i.e., the result is the same as though the agreement had included the provisions required for the primary or alternate tests). The **primary test** ordinarily applies to allocations to **general partners** for which the partnership agreement requires the following.

1. Maintenance of capital accounts in accordance with the rules in Treas. Reg. §1.704-1(b)(2)(iv)[40]

2. Liquidating distributions to be made in accordance with positive capital account balances

3. An unconditional obligation of the partner to restore a capital account deficit following the liquidation of their interest[41]

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36. IRC §761(c); Treas. Reg. §1.761-1(c).

37. Treas. Reg. §1.704-1(b)(2)(ii)(h).

38. The testing of an allocation for SEE essentially requires consideration of a hypothetical liquidation, with a sale of the partnership's assets at FMV (which for certain types of allocations is presumed to be book value). See Treas. Reg. §1.704-1(b)(3)(iii) (partner's interest in partnership when neither a DRO or QIO applies, determined by assuming a hypothetical liquidation in which all partnership property is sold at book value and allocations are made comparing the results with and without the special allocation provision).

39. Treas. Reg. §1.704-1(b)(2)(i).

40. These rules include the basic provision for adjusting capital accounts with respect to contributions, distributions and distributive shares of income, gain, loss, and deduction that parallel the basis adjustment rules in §705, as well as specialized rules, such as the one providing for a "book up" or "book down" in book values upon the entrance of a new contributing partner and in similar circumstances.

41. Treas. Reg. §1.704-1(b)(2)(ii)(b).

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Unless the partnership provisions are intended to make all allocations in line with the partners' interests in the partnership, the **alternate test** generally applies to **limited partners.** The alternate test requires the following.

1. The partnership agreement satisfies the first two requirements of the primary test as to maintaining accounts in accordance with the rules and liquidating according to positive capital account balances.
2. The partner either has no obligation to restore a capital account deficit (deficit restoration obligation (DRO)), or has only a limited DRO (such as provided by a call agreement or a note that must be satisfied within 90 days of liquidation).[42]
3. The partnership agreement includes a "qualified income offset" (QIO) provision. The QIO requires the partnership to make allocations of income, including gross income if necessary, to the partner who does not have a DRO at the end of any tax year in which an **unexpected** distribution or other adjustment makes the partner's capital account negative. This is done in order to restore the account as quickly as possible.[43]

If a partnership includes such provisions, then the economic effect test is satisfied for a partner with a limited DRO **only as long as** the tested allocation does **not** create a deficit balance in the partner's capital account beyond the extent of any limited DRO the partner may have. In testing allocations to see whether they satisfy this requirement, the accounting rules require the partnership to look ahead to consider certain **expected** distributions and adjustments. If the distributions contemplated by the test allocations create a negative balance in the partner's capital account beyond the permissible limit, the allocation does not have economic effect to that extent and must be reallocated to another partner.[44]

Example 9. Mona and Nathan each contribute $80,000 cash to form general partnership MN.[45] The partnership purchases a property for $160,000. The agreement provides that Mona and Nathan will have equal shares of partnership cash flow and partnership taxable income or loss (determined without cost recovery deductions) and that all cost recovery deductions will be allocated to Mona. The partnership agreement satisfies both the primary test for economic effect (each partner has a DRO) and the alternate test (the agreement includes a QIO).

The partnership breaks even in the first year, except for cost recovery deductions of $40,000. At that time, the partnership does not expect any net distributions in future years that would cause or increase a deficit balance in Mona's capital account.

In the second year, the partnership again breaks even except for its cost recovery deduction of $50,000.

Question 9A. Is the special allocation of the cost recovery deduction to Mona honored in the first year?

Answer 9A. The balance sheet of the partnership shows the following, taking into account the cost recovery deductions allocated to Mona.

	MN Partnership	Mona	Nathan
Contributions	$160,000	$80,000	$80,000
Year 1 cost recovery allocation	(40,000)	(40,000)	0
End of year 1 capital accounts	$120,000	$40,000	$80,000
Year 2 cost recovery allocation	(50,000)	(50,000)	0
End of year 2 capital accounts	$ 70,000	($10,000)	$80,000

There is no question about the first year's cost recovery allocation to Mona. It does not cause her capital account to become negative, and it is honored because the allocation satisfies the primary test.

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42. Treas. Reg. §1.704-1(b)(2)(iv)(c).

43. Treas. Reg. §1.704-1(b)(2)(ii)(d)(3).

44. Treas. Reg. §§1.704-1(b)(2)(ii)(d)(3) and 1.704-1(b)(2)(ii)(d)(4)–(6). The regulations presume that the value of partnership property is its book value for these purposes. Treas. Reg. §1.704-1(b)(2)(ii)(d)(6).

45. This is derived from Treas. Reg. §1.704-1(b)(5), Example 1(v).

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Question 9B. What about the second year?

Answer 9B. The second year allocation creates a deficit of $10,000 in Mona's capital account. To test that, consider a sale of the property for its book value. If the property were sold immediately after the end of the second year for $70,000, that $70,000 would be distributed to Nathan from the sales proceeds and Mona would transfer $10,000 to the partnership for distribution to Nathan with respect to her obligation to restore a deficit capital account. Accordingly, the allocations in both years are respected.

Example 10. ABC Partnership (ABC-PS) has a general partner, Alan, and a limited partner, Brenda. Each partner contributed $200,000 and ABC-PS bought property for $400,000. The property is depreciated using the straight-line method (with no midyear convention) over 10 years ($40,000 per year).

The partnership agreement includes a DRO for Alan but not for Brenda. The agreement also includes a QIO provision. The agreement allocates the cost recovery on the property entirely to Brenda.

ABC-PS breaks even other than the cost recovery allocation (gross income of $40,000 and expenses of $40,000).

Question. If there is an **expected** distribution of $40,000 to each partner to be made in year 5, is the cost recovery allocation to Brenda in year 5 respected?

Answer. The special allocation in year 5 will **not** be respected. After years 1 through 4, Brenda's capital account has been reduced to $40,000 ($200,000 – ($40,000 × 4)) by her distributive shares of the cost recovery loss. Those allocations have economic effect under the alternative test because they do not cause Brenda to have a deficit in her capital account. The distribution in year 5 is expected and would itself reduce Brenda's capital account to zero. Therefore, the special allocation of cost recovery deductions for year 5 will not be respected because it would cause Brenda to have a deficit capital account for which she has no DRO.[46] The QIO provision does not come into play — it only applies when there is an **unexpected** net distribution that causes an impermissible deficit.

Example 11. Use the same facts as **Example 10,** except Brenda also contributed a nonnegotiable promissory note for $35,000 to the partnership when she joined. The note requires payment no later than 90 days after liquidation of the partnership (or Brenda's exit).

Question. Will the special allocation of the cost recovery loss be respected in year 5 in these circumstances?

Answer. The promissory note is not treated as a capital contribution and does not give Brenda basis in the partnership interest. However, it does count as a limited DRO under Treas. Reg. §1.704-1(b)(2)(ii)(c)(1). The expected distribution of $40,000 in year 5 reduces Brenda's capital account to zero, as in **Example 10,** but she now has a limited DRO from the note and therefore is allowed to have a deficit balance to that extent. Brenda can be allocated $35,000 of the cost recovery allocation in year 5. The additional $5,000 of the cost recovery allocation is reallocated to Alan to prevent Brenda from having a deficit capital account greater than her limited DRO of $35,000.

Note. The preceding two examples demonstrate an important point about whether a special allocation of a partnership item to a partner will be respected. The economic effect test must be performed annually. An allocation may be respected one year but not respected — or respected only in part — the following year.

46. Treas. Reg. §§1.704-1(b)(2)(ii)(d)(3) and 1.704-1(b)(2)(ii)(d)(4)–(6).

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Many practitioners assume that an allocation of loss to a general partner will always be respected under these rules when the general partner's obligations are governed by a state law default provision requiring the general partner to repay creditors upon the liquidation of the partnership. Rev. Rul. 97-38 clarifies that special allocations are assessed on an **annual basis.** Accordingly, in the initial period of a partnership when both general and limited partners still have a positive capital account balance, an allocation with a hypothetical liquidation after a constructive sale of partnership property at book value may **not** require that any partner restore a deficit capital account, because the debt can be paid out of the partners' equity. If the general partner's state-law DRO is not called into play, allocations that create a deficit in the general partner's capital account may not be permitted in their entirety and all or a portion of the item will be reallocated under the PIP rules. If the first two requirements of the primary test for economic effect are satisfied but there is no DRO or QIO, the PIP reallocation is accomplished by considering a hypothetical liquidation of the partnership after a disposition of its property at book value, with and without the special allocation in question.[47]

Example 12. General partner George and limited partner Louisa each contribute $200,000 to the PS partnership. George is obligated under state law to repay creditors upon the liquidation of the general partnership if there are insufficient funds at the time of liquidation.

PS borrows $1.6 million as a general obligation of the partnership and buys property for $2 million. The property is depreciated on a straight-line basis at $400,000 a year (disregarding midyear conventions) and PS is expected to break even other than the cost recovery allocation in the first five years. The PS agreement calls for George to be allocated all items of depreciation from the property.

Question 12A. Is the cost recovery allocation (CRA) respected in the first year of the partnership?

Answer 12A. If the entire CRA to George were respected, PS's balance sheet would include the following items (at book value) at the end of the tax year.

PS Assets		Book
Property cost		$2,000,000
Year 1 CRA		(400,000)
Total assets		$1,600,000

PS Liabilities and Equity		
Liabilities		$1,600,000
Equity		
George's contribution	$200,000	
George's year 1 CRA	(400,000)	
	($200,000)	(200,000)
Louisa's contribution		200,000
Total liabilities and equity		$1,600,000

This leaves George with a negative capital account, so the economic effect test asks whether he will indeed have a deficit restoration obligation in these circumstances. The tentative allocation of the loss to George is tested under the PIP rules with a constructive sale at FMV (assuming FMV equals book value) with and without this special allocation of the CRA.

47. Treas. Reg. §1.704-1(b)(3)(iii)(b).

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PS sells the building for $1.6 million ($2 million original book value – $400,000 CRA). This $1.6 million is sufficient to repay the creditor in full, so George's state law obligation to repay a creditor upon liquidation is **not** called into play. Therefore, George cannot "go negative" in his capital account. The CRA could have been allocated equally to George and Louisa without causing either partner to have a capital account deficit. Therefore, the $400,000 CRA to George for this first year must be partially reallocated in accordance with the partners' interests in the partnership: $200,000 to Louisa and $200,000 to George.

PS Assets		**Book**
Property cost		$2,000,000
Year 1 CRA		(400,000)
Total assets		$1,600,000
PS Liabilities and Equity		
Liabilities		$1,600,000
Equity		
George's contribution	$200,000	
George's year 1 CRA	(200,000)	
	$ 0	0
Louisa's contribution	200,000	
Louisa's year 1 CRA	(200,000)	
	$ 0	0
Total liabilities and equity		$1,600,000

Question 12B. Is the special allocation to George respected in the second year?

Answer 12B. After the first year, Louisa cannot take on more losses, because her capital account is already reduced to zero and she does not have even a limited DRO. (There are no increases to her capital account unless she makes a new contribution or the partnership has net income, neither of which is applicable here.) The special allocation of the CRA to George for the second year will be respected, because he would be required to make a payment to the creditor in the amount of the capital account deficit upon liquidation.

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Substantiality

The second part of the SEE test requires that there be a "reasonable possibility" that the allocation will substantially affect the dollar amounts to be received by the partners from the partnership, independent of tax consequences.[48] The underlying concern here is that economic factors, not tax considerations, drive the allocations. This is necessarily a less objective test than the economic effect test. The allocations are not substantial if there is a strong likelihood, at the time the allocations become part of the agreement, that:

- The net increases and decreases to the partners' capital accounts will be the same at the end of the tax year to which they apply as they would have been without the special allocations, and
- The total taxes of the partners for such year will be reduced as a result of those allocations.

The second sentence of the regulation describing the substantiality requirement provides a more specific instance. Sometimes called the "one better off; none worse off" test, it states that an allocation will **fail** the substantiality test if:

- The after-tax economic consequences for at least one partner may be better with the allocation than without it, and
- There is a "strong likelihood" that the after-tax consequences for none of the partners will be worse with the allocation than without it (all in present value terms).

The test takes into account the partners' tax attributes that are **unrelated** to the partnership in making the "better off/ worse off" determination.

In addition to this general substantiality test, there are two particular types of allocations that are **not** substantial.

1. **Shifting allocations** taking place within a single tax year
2. **Transitory allocations** taking place across several tax years

A **shifting allocation** is one that is essentially canceled out, as far as changing the result from what the regular allocation would have been, in the same partnership tax year in which it applies. Under the regulatory definition, a shifting allocation occurs when, at the time the allocation becomes part of the partnership agreement, there is a strong likelihood that:

1. The net increases and decreases in the partners' capital accounts for the year will not differ substantially from those that would have been recorded without the allocation, and
2. The total tax liability for the partners for their respective tax years that includes the partnership tax year will be less than without the special allocations (taking into account the partners' particular tax attributes).[49]

If the allocation has this result, there is a rebuttable presumption that there was a strong likelihood of the result at the time the allocation became part of the agreement.[50] Shifting allocations frequently are driven by the particular character of the partnership's income: They are designed to ensure maximum tax reduction by the partners when one partner has a particular tax attribute that another lacks, such as a partner who has capital gains that can be offset by a partnership's capital losses, a partner with expiring net operating losses, or a partner who is a foreign resident who can exclude foreign source income from U.S. taxation.

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48. Treas. Reg. §1.704-1(b)(2)(iii)(a).
49. Treas. Reg. §1.704-1(b)(2)(iii)(b)(1)–(2).
50. Ibid.

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A **transitory allocation** is one that is essentially canceled out by an offsetting allocation, as far as changing the result from what the regular allocation would have been, after a predictable number of partnership tax years in which the original special allocation applies. Under the regulatory definition, a transitory allocation exists when one or more **original allocations** will be **largely offset** by one or more **offsetting allocations** and, at the time the special allocation provisions enter the partnership agreement, there is a strong likelihood that:

1. The net increases and decreases in the partners' capital accounts for the tax years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded without the special allocations, and
2. The total tax liability of the partners for their respective tax years will be less than if the special allocations were not included in the agreement.[51]

There is again a rebuttable presumption that if there is such a result, there must have been a strong likelihood that it would occur at the time the special allocations were added to the agreement.

Exceptions to these rules cover partnership income chargeback and gain chargeback provisions. Without these exceptions, such provisions in an agreement would clearly violate the substantiality requirement because a chargeback of income is generally **intended** to offset prior allocations of losses, and a chargeback of gain is generally **intended** to offset prior cost recovery allocations. The income chargeback exception presumes that there is a reasonable possibility that the allocations **will** substantially affect the actual economics if there is **not** a strong likelihood that the offsetting allocations will be made, in large part, within five years of the original allocations.[52]

Note. Partnerships with income chargeback provisions may encounter problems with this substantiality test if there are expected losses in the partnership's business along with a predictable stream of income from sources such as bonds or rental properties.

The gain chargeback provision provides that there cannot be a strong likelihood of reversal of the original loss allocations by offsetting gain allocations upon a later disposition, because, until the actual sale, the FMV of the property will be presumed to be equal to its book value.[53] Accordingly, at the time the provisions become part of the agreement, no gain can be expected from appreciation.

Note. This ensures that partnerships that charge cost recovery allocations on properties to a partner can include provisions to require that partner to take any gain on disposition into account up to the amount of those cost recovery allocations. Because it is assumed that there is no appreciation above book value for testing the allocation of the losses, the fact that there is likely to be appreciation by the time the property is sold and the gain chargeback comes into play is irrelevant.

51. Treas. Reg. §1.704-1(b)(2)(iii)(c)(1)–(2).

52. Treas. Reg. §1.704-1(b)(2)(iii)(c).

53. Ibid.

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Example 13. Alonzo and Bailey are partners.[54] The partnership agreement allocates most items equally. The partnership has $12,000 in tax-exempt interest income (TEI) and $12,000 in taxable dividend income (DIV). Alonzo is in a high tax bracket (30%) and Bailey is in a low tax bracket (15%). At a time when there is a strong likelihood that the partnership will have between $11,900 and $12,100 of both TEI and DIV income, the partnership agreement is amended to allocate 90% of the TEI to Alonzo and 10% to Bailey and to allocate 100% of the DIV to Bailey.

Question. Assuming that this allocation has economic effect, is it respected as substantial?

Answer. This allocation satisfies the economic effect test. (There is no question of a partner's capital account having a deficit beyond any DRO the partner may have.) The question is whether it is substantial. The primary way to test this type of allocation for substantiality is to compare the results to the partners with and without the special allocation, taking into account the particular tax attributes (such as tax-rate brackets) of the partners.

Result with Special Allocation

	Alonzo	Bailey
TEI (90%/10% allocation)	$10,800	$ 1,200
DIV (100% to Bailey)	0	12,000
Total income	$10,800	$13,200
Income tax	0	(1,800)
Income after tax	$10,800	$11,400

Result without Special Allocation

	Alonzo	Bailey
TEI (50%/50% allocation)	$ 6,000	$ 6,000
DIV (50%/50% allocation)	6,000	6,000
Total income	$12,000	$12,000
Income tax	(1,800)	(900)
Income after tax	$10,200	$11,100

Both Alonzo and Bailey are better off in after-tax income with the special allocation compared to the regular 50-50 allocation; neither is worse off. The special allocation **fails** the substantiality test.

[54] This example is based on Treas. Reg. §1.704-1(b)(5), Example 5.

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Example 14. Because the allocation in **Example 13** failed the substantiality test, the partnership must reallocate the DIV and TEI in accordance with the partners' interests in the partnership (PIP). What is the PIP for each partner in this case?

With the special allocation, Alonzo got 45% ($10,800 ÷ $24,000) of the total gross income from DIV and TEI, and Bailey got 55% ($13,200 ÷ $24,000). Therefore, the reallocation in accordance with PIP is 45% of **each type of income** to Alonzo and 55% of **each type** to Bailey.[55]

The result of the reallocation according to the partners' interests is that Alonzo, the high-tax bracket partner who was the primary beneficiary of the tax-motivated shift of the allocations, fares particularly poorly.

Result with Allocation of TEI and DIV per PIP

	Alonzo	Bailey
TEI (45%/55% allocation)	$ 5,400	$ 6,600
DIV (45%/55% allocation)	5,400	6,600
Total income	$10,800	$13,200
Income tax	(1,620)	(990)
Income after tax	$ 9,180	$12,210

Example 15. Ethan and Faith are equal partners in EF Partnership, a general partnership formed to acquire and operate property that satisfies the §1231(b) definition of property used in a trade or business.[56] Ethan, Faith, and EF Partnership have calendar tax years. The partnership agreement contains provisions satisfying the primary test for economic effect.

In year 6 of the partnership, the partnership expects to have a loss on a disposition of a portion of its business property. Ethan and Faith make a timely modification of the agreement to allocate the loss to Ethan for that year only, and to allocate an equal amount of partnership losses and deductions, of a different character, to Faith. All other losses and deductions are allocated equally. At the time the modification is made, the partnership expects to have losses from sales of securities and other properties that substantially exceed the losses that it will have from §1231 properties in that year. However, Ethan expects to have no gains from §1231 properties that year.

Question. Will the allocation of losses to Ethan from §1231 property be respected?

Answer. No, the allocation will not be respected. Because Ethan expects no §1231 gains, it is likely that the §1231 loss allocated to him will be a net §1231 loss and will be treated as an ordinary deduction against other income that he may have. This would result in a reduced tax liability for him because of the special allocation. The special allocation of §1231 losses will have economic effect but it will not be substantial, because there is a strong likelihood, at the time the allocations become part of the agreement, that the net increases and decreases to both partners' capital accounts will be the same at the end of the tax year as they would have been without the allocations and that the total taxes paid by Ethan and Faith will be less than they would have been without the allocations.

55. See Treas. Reg. §1.704-1(b)(5), Example (5)(ii).

56. This example is based on Treas. Reg. §1.704-1(b)(5), Example 6.

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Example 16. Caren and Dale each contribute $100,000 to form a general partnership.[57] The partnership holds property with a 5-year recovery period. The partnership obtains a recourse loan of $800,000 to purchase $1 million of equipment. The partnership agreement provides that Caren will be allocated 90% of net taxable loss and Dale will be allocated 10%, until such time as the partnership has net income. After that, Caren will be allocated 90% of the net taxable income until the allocations of income have fully offset the allocations of losses. After that, the partners will share all items equally.

Expected operating results can be predicted with considerable certainty. The partnership will have a $100,000 loss in the first year and the losses will decrease by $10,000 in each succeeding year, ending with a $60,000 loss in year 5. There will be a $40,000 profit in year 6 and the profits will increase by $10,000 a year through year 12, when a profit of $100,000 can be expected.

Question. Are the allocations of losses to Caren and the related income chargebacks respected?

Answer. Clearly, the provision provides for early allocations of taxable losses to be offset by later allocations of taxable income, a situation that raises a question of whether the allocations will fall under the **transitory** allocation rule for substantiality. There is a mechanical "first-in, first-out" rule for determining whether income offsets prior allocations of losses. As shown in the following table, none of the losses in years 1 through 5 are "largely offset" within five years; therefore, the allocations **are** respected under the income chargeback exception to the transitory rule for substantiality.

Year	Partnership Loss	Partnership Income	Caren	Dale	Offsets	Remaining
1	($100,000)		($90,000)	($10,000)		
2	(90,000)		(81,000)	(9,000)		
3	(80,000)		(72,000)	(8,000)		
4	(70,000)		(63,000)	(7,000)		
5	(60,000)		(54,000)	(6,000)		
6		$ 40,000	36,000	4,000	Year 1 ($40,000)	$60,000
7		50,000	45,000	5,000	Year 1 (50,000)	10,000
8		60,000	54,000	6,000	Year 1 (10,000)	
					Year 2 (50,000)	40,000
9		70,000	63,000	7,000	Year 2 (40,000)	
					Year 3 (30,000)	50,000
10		80,000	72,000	8,000	Year 3 (50,000)	
					Year 4 (30,000)	40,000
11		90,000	81,000	9,000	Year 4 (40,000)	
					Year 5 (50,000)	10,000
12		100,000 [a]	54,000	46,000	Year 5 (10,000)	
Totals	($400,000)	$490,000	$45,000	$45,000		

[a] To offset the last $10,000 of the losses, Caren will receive $9,000 of income and Dale will receive $1,000 of income. That leaves $90,000 of income to be allocated equally under the new allocation provision that becomes effective at that point.

57. This example is based on Treas. Reg. §1.704-1(b)(5), Example 2.

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Example 17. Alicia and Brad each contribute $200,000 to A-B Partnership. A-B purchases property for $400,000. For book cost recovery and tax depreciation purposes, the property is depreciated straight line over 10 years at $40,000 per year. The property's FMV remains constant at the initial value over the 10-year period.

Question. If the partnership agreement allocates all of the cost recovery allocations to Alicia and provides that she will take into account an amount of gain equal to the cost recovery deductions allocated to her upon a disposition of the property, can the cost recovery allocations and gain chargeback be honored?

Answer. Yes, these allocations satisfy the substantiality requirement (assuming no economic effect issues), under the exception to the transitory rule regarding offsetting allocations in later years for gain chargeback provisions. The following table shows "actual gain" versus "value equals basis" gain for the first two years.

	Actual Gain Determination		Value = Basis (book if different) Gain Determination	
Year 1	Beginning adjusted basis	$400,000	Beginning adjusted basis	$400,000
	Depreciation	(40,000)	Depreciation	(40,000)
	Adjusted basis	$360,000	Adjusted basis	$360,000
	Actual offset gain if sold (FMV = $400,000)	40,000	Likely offset gain (FMV deemed = $360,000)	0
Year 2	Beginning adjusted basis	$360,000	Beginning adjusted basis	$360,000
	Depreciation	(40,000)	Depreciation	(40,000)
	Adjusted basis	$320,000	Adjusted basis	$320,000
	Actual offset gain if sold (FMV = $400,000)	80,000	Likely offset gain (FMV deemed = $320,000)	0

Note. The "value equals basis" rule of Treas. Reg. §1.704-1(b)(2)(iii)(c) says that the FMV will be deemed to be the same as basis (or book, if they differ). Tax basis and book value correspond in **Example 17,** because the book value and the tax basis are decreased for depreciation at the same rate. In cases in which tax basis and book value do not correspond, the "value equals basis" rule refers to book.

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IRC §704(C) BUILT-IN GAIN OR LOSS ALLOCATIONS ON CONTRIBUTED PROPERTY

Contributions of property for which there is a "book-tax disparity" (because the transferring partner has a basis that is less than the FMV at the time of contribution) create considerable complexity in the partnership rules. The partnership is generally viewed as an aggregate, with each partner owning an undivided interest in each property owned by the partnership. However, there is no "catch-up" taxation of precontribution gains to contributing partners. Absent any type of adjustment, this would result in a contributing partner being able to shift precontribution gain to the other partners (who might be willing to bear that gain either because they have particular tax attributes that make it less burdensome or because they work out a partnership deal to their advantage using this issue as leverage). IRC §704(c) and the regulations thereunder are intended to prevent this kind of shifting between partners by specially allocating items related to precontribution gain or loss to the contributing partner.[58] The contributing partner has a basis in their partnership interest that is less than the book capital account, and the partnership has a corresponding difference between the inside basis and book value of the property. The precontribution gain (or loss) is specially allocated to the contributing partner to the extent it is recognized upon a later disposition of the property (or gradually over time through depreciation or amortization).

Any gain on disposition in excess of the precontribution gain is allocated in accordance with the regular partnership provisions for allocating gain among the partners. The key to understanding how these rules work is that the tax allocations are expected to follow the book allocations for the noncontributing partners, to the extent possible. The precontribution tax items are uniquely allocable to the contributing partner; thus, the contributing partner takes into account, for tax purposes, the tax items relating to the book-tax disparity created by the contribution.

The regulations provide three methods for this special allocation of precontribution gain or loss.

1. The traditional method
2. The traditional method with curative allocations
3. The remedial method

Traditional Method and Ceiling Rule

Upon disposition, the FMV may not be sufficient to provide tax items for noncontributing partners that correspond to the book items that they are allocated.

> **Observation.** Similar shortfalls can occur with depreciation if a noncontributing partner is allocated considerable book depreciation but the basis is so low that there is only negligible tax depreciation to allocate to the partner. The partnership generally steps into the shoes of the contributing partner, with depreciation continuing for the remainder of the useful life of the depreciable property.

To the extent possible, the amount of a noncontributing partner's tax deductions are limited to the amount of the book allocations to those partners. The built-in gain or loss amount on §704(c) property is allocated to the contributing partner at the time the partnership disposes of the contributed property. However, the total income, gain, loss, or deduction allocated to the partners for a tax year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction for that property for the tax year. This is called the **"ceiling rule."**[59]

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58. Treas. Reg. §1.704-3(a)(1).

59. Treas. Reg. §1.704-3(b)(1).

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Applying the traditional method under §704(c) requires the following steps.

1. Calculate the book item for the property (gain or loss on the sale or the book cost recovery allocation) and record this in the partnership's book accounts. If it is a sale, this means eliminating the asset from the books and adjusting the book account for cash. If it is a cost recovery allocation, this results in a downward adjustment to the book account for the asset. Book cost recovery uses the same method as used for tax depreciation.

2. Allocate the book item to the partners according to the partnership agreement. Generally, because the book item represents the postcontribution change in the property, both the contributing partner and the noncontributing partners share in the book item.

3. Calculate the tax item for the property (gain or loss on the sale or tax depreciation) and record that as an adjustment to the partnership's inside basis. If this is a sale, this means adjusting the tax basis for cash. If it is depreciation, this results in a downward adjustment to the tax basis for the asset.

4. Allocate to **noncontributing** partners a share of the tax item matching their shares of the book item, to the extent possible. If it is not possible to give the noncontributing partners a corresponding tax item for the book item they received, the ceiling rule applies: The actual items with respect to the property act as a limitation to prevent the introduction of new book-tax disparities.

5. Allocate to the **contributing** partner a share of the tax item matching the book item allocated. This will only be possible if the ceiling rule did not apply and may not be possible even if the allocations for the noncontributing partners did not bring the ceiling rule into effect. The inability to give the contributing partner a tax allocation equal to that partner's book allocation is not itself a ceiling rule problem.

6. Allocate the precontribution tax item (gain or loss) to the extent available to the contributing partner.

The following five examples demonstrate traditional allocations in sales and depreciation of an asset.

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Example 18. Aaron and Bonnie each contributed nondepreciable property with a value and basis of $100,000 to the ABC Partnership and Cathy contributed nondepreciable property with a basis of $80,000 and a value of $100,000. The partnership agreement provides that the partners share equally in items of income, expense, gain, and loss with respect to the property. The partnership's balance sheet follows.

Partnership Assets	Basis	Book
Property contributed by Aaron	$100,000	$100,000
Property contributed by Bonnie	100,000	100,000
Property contributed by Cathy	80,000	100,000
Total assets	$280,000	$300,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Aaron	100,000	100,000
Partner Bonnie	100,000	100,000
Partner Cathy	80,000	100,000
Total liabilities and equity	$280,000	$300,000

Question. What is the result 10 years later when the partnership sells the property contributed by Cathy for $100,000?

Answer. If the partnership sells the property contributed by Cathy for $100,000, there is no book gain ($100,000 amount realized – $100,000 book value = $0 book gain) to consider. There is a tax gain of $20,000 ($100,000 amount realized – $80,000 basis), which must be allocated to contributing partner Cathy under the special allocation rules of §704(c). (Precontribution gain can only have a tax effect, so allocations of it cannot be tested under the regular SEE rules.)

The partnership's balance sheet after the sale and allocation of distributive shares shows that the disposition completely "corrected" the book-tax disparity, requiring Cathy to take into account the entire gain.

Partnership Assets	Basis	Book
Property contributed by Aaron	$100,000	$100,000
Property contributed by Bonnie	100,000	100,000
Cash from sale	100,000	100,000
Total assets	$300,000	$300,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Aaron	100,000	100,000
Partner Bonnie	100,000	100,000
Partner Cathy	100,000	100,000
Total liabilities and equity	$300,000	$300,000

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Example 19. Use the same facts as **Example 18,** except the partnership sells the property for $130,000.

Question. What is the result for Cathy and the noncontributing partners?

Answer. There is a postcontribution book gain of $30,000 and precontribution and postcontribution tax gains of $50,000. Each of the partners is allocated $10,000 of the book gain under the equal sharing provision of the partnership. Each of the partners is also allocated $10,000 of the tax gain. The ceiling rule does not come into play. Cathy is also allocated the remaining tax gain, which represents the full precontribution gain of $20,000. Cathy therefore has a $30,000 distributive share of the tax gain and a $10,000 distributive share of the book gain. Cathy's basis is now $110,000 ($80,000 + $10,000 + $20,000).

Partnership Assets	Basis	Book
Property contributed by Aaron	$100,000	$100,000
Property contributed by Bonnie	100,000	100,000
Cash from sale	130,000	130,000
Total assets	$330,000	$330,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Aaron	110,000	110,000
Partner Bonnie	110,000	110,000
Partner Cathy	110,000	110,000
Total liabilities and equity	$330,000	$330,000

Example 20. Use the same facts as **Example 18,** except the partnership sells the property for $90,000.

Question. What is the result for Cathy and the noncontributing partners?

Answer. There is a postcontribution book loss of $10,000 ($100,000 book – $90,000 amount realized), and there is a tax gain of $10,000 ($90,000 amount realized – $80,000 basis) relating to Cathy's precontribution gain in the property. Each of the partners is allocated one-third of the postcontribution book loss (approximately $3,333 each). But the noncontributing partners cannot be "held harmless." Under the traditional rule, they bear the economic burden of the postcontribution book loss without receiving corresponding tax items. (The tax here cannot follow book because of the ceiling rule.) A new book-tax disparity for **noncontributing** partners is created. Cathy is allocated the entire $10,000 of precontribution tax gain that is recognized on the disposition.

Partnership Assets	Basis	Book
Property contributed by Aaron	$100,000	$100,000
Property contributed by Bonnie	100,000	100,000
Cash from sale	90,000	90,000
Total assets	$290,000	$290,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Partner Aaron	100,000	96,666
Partner Bonnie	100,000	96,667
Partner Cathy	90,000	96,667
Total liabilities and equity	$290,000	$290,000

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Example 21. Angela and Bethany form AB Partnership. Angela contributes depreciable property with a basis of $100,000 and value of $200,000, and Bethany contributes property with a basis and value of $200,000. The property Angela contributes depreciates for tax purposes for 10 years at $10,000 per year. The corresponding book cost recovery allocation is $20,000 per year.

Question. Is the ceiling rule a factor in the depreciation allocations?

Answer. No, the ceiling rule is not a factor here. The book cost recovery allocations are shared equally between Angela and Bethany, lowering each partner's capital account by $10,000 each year. Bethany, the noncontributing partner, is allocated tax depreciation equal to the cost recovery allocation of $10,000, leaving no tax depreciation for Angela to take into account. Because Bethany is held harmless (no new book tax disparity for Bethany is created), the ceiling rule does not come into play. Angela is essentially taking her precontribution gain into account by forgoing the depreciation tax deduction corresponding to the cost recovery deduction she is allowed for book purposes.

Partnership Assets	Basis	Book
Property contributed by Bethany	$200,000	$200,000
Property contributed by Angela	100,000	200,000
Year 1 CRA (book)		(20,000)
Year 1 depreciation (tax)	(10,000)	
Total assets	$290,000	$380,000

Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Angela's contribution	100,000	200,000
Angela's Year 1 CRA		(10,000)
Bethany's contribution	200,000	200,000
Bethany's Year 1 CRA		(10,000)
Bethany's tax depreciation	(10,000)	
Total liabilities and equity	$290,000	$380,000

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Example 22. Use the same facts as **Example 21,** except Angela's basis in the property is only $30,000 at the time of contribution.

The cost recovery for book purposes is still $20,000, but the tax depreciation is only $3,000. Both Angela and Bethany are allocated $10,000 of the book item. Bethany is allocated all of the tax depreciation. Nonetheless, these allocations are impacted by the ceiling rule, because there is not a sufficient amount of tax depreciation to hold the noncontributing partner harmless.

Partnership Assets	Basis	Book
Property contributed by Bethany	$200,000	$200,000
Property contributed by Angela	30,000	200,000
Year 1 CRA (book)		(20,000)
Year 1 depreciation (tax)	(3,000)	
Total assets	$227,000	$380,000

Partnership Liabilities and Equity	Basis	Book
Liabilities	$ 0	$ 0
Equity		
Angela's contribution	30,000	200,000
Angela's Year 1 CRA		(10,000)
Bethany's contribution	200,000	200,000
Bethany's Year 1 CRA		(10,000)
Bethany's tax depreciation	(3,000)	
Total liabilities and equity	$227,000	$380,000

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Traditional Method with Curative Allocations

Distortions caused by the ceiling rule under the traditional method can be "cured" when a partnership uses the traditional method with curative allocations.[60] This is done by **misallocating** the tax items (but not the book items) for other partnership income, expense, gain, or loss, if the items satisfy the character and other limitations in the regulations.[61]

Example 23. Use the same facts as **Example 20,** except that the partnership had a provision requiring curative allocations for such sales. The partnership also owned similar property that was sold in the same year, resulting in a book and tax loss of $20,000.

Question. What is the result for the partners when the curative allocations are taken into account?

Answer. As before, there is a postcontribution book loss of $10,000 ($100,000 book – $90,000 amount realized), and there is a tax gain of $10,000 ($90,000 amount realized – $80,000 basis) relating to Cathy's precontribution gain in the property she contributed. Each of the partners is allocated one-third of the postcontribution book loss on that property (approximately $3,333 each). Each of the partners is also allocated one-third of the book loss on the second property (approximately $6,666 each).

Without further adjustments, the ceiling rule will result in a new book-tax disparity (because the noncontributing partners should be allocated a tax loss equal to their book loss on the property contributed by Cathy) but no tax loss with respect to that property. Because the partnership agreement has a curative provision, however, $6,666 of the tax loss with respect to the other property can be misallocated from Cathy to the noncontributing partners to cure the distortion caused by the ceiling rule on the property she contributed.

Aaron and Bonnie will each receive $10,000 of the tax loss with respect to the second property, and Cathy will receive none of the tax loss with respect to the second property. Cathy will be allocated only the $10,000 of precontribution tax gain that is recognized on the disposition of the property she contributed. **This cures the book-tax disparity.** Cathy has effectively taken her precontribution gain into account in two ways — by including her distributive share of the $10,000 tax gain in income and by **not** getting a distributive share of the tax loss that she can use on her return for the $10,000 economic loss she bears on the second property.

Partnership Assets	**Basis**	**Book**
Property contributed by Aaron	$100,000	$100,000
Property contributed by Bonnie	100,000	100,000
Other property (sold for $20,000 less than basis and book)	(20,000)	(20,000)
Cash from sale	90,000	90,000
Total assets	$270,000	$270,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Aaron	90,000 [a]	90,000 [b]
Bonnie	90,000 [a]	90,000 [b]
Cathy	90,000 [c]	90,000 [b]
Total liabilities and equity	$270,000	$270,000

[a] $100,000 contribution — $10,000 tax loss

[b] $100,000 contribution — $3,333 book loss on Cathy's property — $6,666 book loss on other property (rounded)

[c] $80,000 contribution + $10,000 tax gain

[60] Treas. Reg. §1.704-3(c).

[61] Treas. Reg. §1.704-3(c)(3), which requires that curative allocations be reasonable in amount, timing, and type.

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Remedial Method

The remedial method of remedying the distortion caused by the ceiling rule is in many ways much simpler. If a partnership uses the remedial method and is impacted by the ceiling rule, the partnership merely "invents" notional remedial items as necessary to prevent the noncontributing partners from suffering any distortion caused by inadequate tax items corresponding to the book items allocated to them.[62] Offsetting remedial items are created and allocated to the contributing partner. These notional remedial items have no effect on the partnership's asset bases or taxable income, nor do they affect the partners' book capital accounts.[63] They are, nonetheless, "real" for purposes of determining the partners' distributive shares included on their tax returns and their resulting outside bases.

Example 24. Use the same facts as **Example 20,** except the partnership provides for remedial allocations whenever the ceiling rule applies.

Question. What remedial allocations are made, and to whom?

Answer. As before, there is a postcontribution book loss of $10,000 and there is a tax gain of $10,000 relating to Cathy's precontribution gain in the property she contributed. Each of the partners is allocated one-third of the postcontribution book loss on that property (approximately $3,333 each). Without further adjustments, the ceiling rule will result in a new book-tax disparity because the noncontributing partners should be allocated a tax loss equal to their book loss on the property contributed by Cathy, but there is no tax loss on that property. Because the partnership agreement has a remedial provision, it invents a notional remedial loss of $6,666 (one-half of which is allocated equally to Aaron and Bonnie) and an offsetting remedial gain of $6,666 allocated to Cathy. Cathy is also allocated the $10,000 of precontribution tax gain that is recognized on the disposition of the property she contributed.

Partnership Assets	Basis	Book
Property contributed by Aaron	$100,000	$100,000
Property contributed by Bonnie	100,000	100,000
Cash from sale	90,000	90,000
Total assets	$290,000	$290,000

Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Aaron	96,667 [a]	96,667 [b]
Bonnie	96,667 [a]	96,667 [b]
Cathy	96,666 [c]	96,666 [b]
Total liabilities and equity	$290,000	$290,000

[a] $100,000 contribution − $3,333 remedial tax loss
[b] $100,000 contribution − $3,333 book loss (rounded)
[c] $80,000 contribution + $10,000 tax gain + $6,666 remedial tax gain

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[62] Treas. Reg. §1.704-3(d)(1).

[63] Treas. Reg. §1.704-3(d)(4).

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Depreciation when a partnership uses the remedial method is somewhat more complicated. The regulations require the following steps.[64]

1. **Bifurcate** the book amount that is to be recovered into two parts — one part corresponds to the tax basis to be recovered and the other is the excess of the book amount over the tax basis.
2. The portion of the book amount that corresponds to the tax basis is recovered in the same manner that the tax basis is recovered (generally over the remaining recovery period under IRC §168(i)(7)).
3. The excess book amount is recovered as though it were newly purchased property of the same type as the contributed property.

Example 25. Abe contributes depreciable property with a basis of $100,000 and a value of $200,000 (this is 20-year property with 10 years of depreciation remaining at the time of contribution). Brigitte contributes nondepreciable property with a book value and a basis of $200,000. The partners share equally in income, gain, expenses, and losses. The partnership uses the remedial method for all purposes.

Question. At what point are remedial allocations required?

Answer. Tax depreciation on the property is $10,000 per year for 10 years. Cost recovery for book purposes is bifurcated into two amounts — $100,000 (equal to the tax basis, to be depreciated at $10,000 per year) and $100,000 (equal to the excess book value, treated as new property depreciable over 20 years, at $5,000 per year). The total book cost recovery each year for the first 10 years is therefore $15,000, of which Abe and Brigitte are each allocated $7,500 because they share equally in all partnership items. After 10 years, there is only the "excess book" cost recovery of $5,000 per year for the remaining 10-year recovery period, which is again shared equally and allocated $2,500 each to Abe and Brigitte.

During the first 10 years, the ceiling rule is not an issue. As a noncontributing partner, Brigitte receives $7,500 of the available tax depreciation to match the book cost recovery allocated to her. Abe receives the remaining $2,500 of the tax depreciation each year.

After the first 10 years, however, there is no longer any tax depreciation on the property, and the ceiling rule is invoked. As the noncontributing partner, Brigitte receives a remedial item of $2,500 in tax depreciation each year to match her $2,500 of book depreciation. As the contributing partner, Abe receives an offsetting remedial item of $2,500 of ordinary tax income. Note that depreciation using the remedial method is set up to ensure a considerable delay in the time for making remedial and offsetting remedial allocations, thus granting the contributing partner significant deferral over what might have been expected for the remedial method.

64. Treas. Reg. §1.704-3(d)(2).

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The partnership's balance sheet after the first 10 years follows.

Partnership Assets	Basis	Book
Property contributed by Abe	$100,000	$200,000
Property contributed by Brigitte	200,000	200,000
Depreciation (total, years 1–10)	(100,000)	(150,000)
Total assets	$200,000	$250,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Abe	75,000 [a]	125,000 [b]
Brigitte	125,000 [c]	125,000 [b]
Total liabilities and equity	$200,000	$250,000

[a] $100,000 contribution − ($2,500 tax depreciation × 10 years)
[b] $200,000 contribution − ($7,500 book depreciation × 10 years)
[c] $200,000 contribution − ($7,500 tax depreciation × 10 years)

The partnership's balance sheet at the end of the 20-year recovery period follows.

Partnership Assets	Basis	Book
Property contributed by Abe	$100,000	$200,000
Property contributed by Brigitte	200,000	200,000
Depreciation (total, years 1–10)	(100,000)	(150,000)
Depreciation (total, years 11–20)	0	(50,000)
Total assets	$200,000	$200,000
Partnership Liabilities and Equity		
Liabilities	$ 0	$ 0
Equity		
Abe	100,000 [a]	100,000 [b]
Brigitte	100,000 [c]	100,000 [b]
Total liabilities and equity	$200,000	$200,000

[a] $75,000 equity at end of Year 10 + ($2,500 remedial tax income × 10 years)
[b] $125,000 equity at end of Year 10 − ($2,500 book depreciation × 10 years)
[c] $125,000 equity at end of Year 10 − ($2,500 remedial tax depreciation × 10 years)

Note. In a small partnership in which only one partner is contributing appreciated property, the remedial method may well be preferred by the noncontributing partners. The contributing partner may well prefer the traditional method, which is likely to provide considerable deferral of the precontribution gain recognition. Like the decision to include a §754 election in the partnership agreement, reaching a decision on the proper method for §704(c) allocations requires a cooperative approach and recognition of the benefits and burdens to each of the partners. Practitioners should be prepared to explain how these different methods work in order to assist partners in the decision.

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GUARANTEED PAYMENTS

Partners may at times provide services to their partnerships that are not related to the fact that they are partners of the partnership and are not within the normal scope of duties expected of general partners of the partnership. In those situations, the compensation is not treated in any way as a distributive share but rather as compensation paid to an independent contractor under IRC §707(a)(1).

These payments to a partner who is not acting in their capacity as a member of the partnership must be contrasted with guaranteed payments to partners who are rendering services to the partnership that are within the normal scope of their duties.[65] Guaranteed payments under §707(c) are payments:

- Made to partners for the use of capital or for services,
- That are determined without regard to the income of the partnership, and
- That are treated as ordinary income to the partners.[66]

Guaranteed payments are paid out of gross income if the partnership has no profits for the year.

Although guaranteed payments are fixed payments for services or for the use of capital that resemble transactions with nonpartners, guaranteed payments are also like distributive shares in that they are treated as made to partners in their capacity as partners for purposes **other than** the inclusion and deduction provisions.[67] A guaranteed payment for capital is equivalent to income earned on an investment (such as a preferred return) for the partner and a preferred return expense (or capitalized expenditure) to the partnership. For partners who receive guaranteed payments for services, the payments are treated as any other wage income; that is, the character of the payments as ordinary income holds regardless of the character of the income to the partnership, and the payments are subject to self-employment tax.

Note. As noted earlier in this chapter, there is considerable controversy about payments to service partners in private equity partnerships. Those partners generally receive a guaranteed payment (called a "fee") as well as a share of partnership profits (called a "carried interest"). Although it is widely acknowledged that the fee is compensation income, the carried interest is generally not treated as compensation income. Various legislative proposals have been introduced to treat the carried interest as compensation income subject to payroll taxes and ordinary income tax rates.

A partnership deducts (or capitalizes)[68] guaranteed payments as it would a payment of compensation (for services) or a payment of a preferred return (for the use of capital), with the timing of the deduction to the partnership under its method of accounting determining the timing of the partner's inclusion.[69] In the case of an accrual partnership and a cash-method partner, a partner may be required to include the guaranteed payment in their tax return prior to its actual receipt from the partnership. The mechanism for preventing double taxation is unclear — it is likely that the partner treats the guaranteed payment as a distributive share, receiving basis in the partnership interest that is then later reduced when the actual payment is made.[70]

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65. See, for example, *Pratt, et al. v. Comm'r,* 64 TC 203 (1975).

66. IRC §707(c); Treas. Reg. §1.707-1(c).

67. IRC §707(c) (referring to §61(c), regarding compensation income, and IRC §162(a), regarding trade or business expenses). The primary characteristic related to distributive share treatment is timing.

68. IRC §§162, 263.

69. IRC §707(c); Treas. Reg. §1.707-1(c) (referencing §706(a), providing that partners' distributive shares are included in income for the partners' tax years within which falls the partnership's tax year to which the item relates); and S. Rept. No. 1622, 83d Cong., 2d Sess. 385 (1954) (noting that the reference under §707(c) to §706(a) was to clarify that the timing of inclusion for the partner depended on the timing of deduction for the partnership).

70. *Gaines, et. al. v. Comm'r,* 45 TCM 363 (1982).

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Example 26. Sam and Max are partners in SM partnership.[71] The partnership agreement includes the following.

- Sam will be paid 30% of partnership profits determined before taking into account any guaranteed amount, **but not less than $100,000.**
- Any guaranteed amount will be treated as an expense of the partnership in any year in which Sam's percentage of profits is less than the guaranteed amount.

There is no explicit provision for sharing capital gains. The partnership's taxable income (without considering any deduction for guaranteed payments) is $200,000 ($120,000 ordinary income + $80,000 capital gains).

Question. What is Sam's guaranteed payment and what is Sam's distributive share (other than the guaranteed payment) of partnership income? What is Max's distributive share of ordinary income and capital gains?

Answer. Sam's share of partnership profits before taking the guaranteed payment into account is $60,000 (30% × $200,000). Because Sam is guaranteed a minimum of $100,000, Sam's guaranteed payment for the year is $40,000 ($100,000 minimum guaranteed − $60,000 distributive share of pre-guarantee profits). Because Sam receives a total of $100,000 of the $200,000 pre-guaranteed payment income, Max receives the remaining $100,000.

Taking the guaranteed payment into account, the partnership has $80,000 of ordinary income ($120,000 − $40,000 guaranteed payment) and $80,000 of capital gains, for total taxable income of $160,000. This means that Sam receives 37.5% ($60,000 distributive share of profits ÷ $160,000) of the partnership's taxable income and Max receives 62.5% ($100,000 distributive share ÷ $160,000). Accordingly, because the partnership agreement does not include any special allocation for capital gains, Max receives $50,000 as his distributive share of capital gains (62.5% × $80,000 capital gain income) and $50,000 as his share of ordinary income (62.5% × $80,000 ordinary income). Sam receives 37.5% of each type of income as well as his $40,000 guaranteed payment of ordinary income, so he has $70,000 (($80,000 ordinary income × 37.5%) + $40,000 guaranteed payment) of ordinary income and $30,000 ($80,000 capital gains × 37.5%) of capital gains.

Agreement Amount

	Sam	Max
Share profits by agreement (30% × $200,000)	$ 60,000	$0
Minimum guarantee − distributive share pre-guarantee ($100,000 − $60,000)	40,000	0
Total	$100,000	$0

Type of Income

Ordinary income ($120,000 − $40,000)	$ 80,000
Capital gains	80,000
Total	$160,000

Allocation by Type of Income

	Sam		Max	
Type of Income	**Calculation**	**Amount**	**Calculation**	**Amount**
Ordinary	$60,000 ÷ $160,000 = 37.5%		$100,000 ÷ $160,000 = 62.5%	
	37.5% × $80,000 = $30,000		62.5% × $80,000 = $50,000	$ 50,000
	$30,000 + $40,000 = $70,000	$ 70,000		
Capital gain	37.5% × $80,000	30,000	62.5% × $80,000	50,000
Total		$100,000		$100,000

71. This example is based on Rev. Rul. 69-180, 1969-1 CB 183.

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Example 27. Use the same facts as **Example 26,** except Sam and MaxCo are the partners of SM partnership. MaxCo and SM partnership are accrual-basis taxpayers with a November 30 yearend, but Sam is a calendar-year, cash-method taxpayer. SM partnership accrues the guaranteed payment in its information return for November 30 of the 2013 tax year but has not yet made the payment.

Question. What income does Sam include in his 2013 tax return?

Answer. Sam must include the distributive shares of ordinary income and capital gain and the guaranteed payment in his 2013 return, even though he has not yet received the payment.

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