

## Chapter 4: Partner Issues

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**Please note.** Corrections were made to this workbook through January of 2018. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

### About the Authors

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## Chapter Summary

Although a partnership is usually not subject to income tax, it is treated as a separate entity for tax reporting purposes. Each partner is then taxed on their distributive share of partnership income or loss.

For tax purposes, a partnership is treated as owning its assets as a separate entity, with its partners owning interests in that entity. Partners' outside bases in their partnership interest are determined separately from the partnership's inside basis in its assets.

The three loss limitations (basis, at-risk, and passive activity) and the order in which they are applied are explained. These rules limit the losses deductible by a partner from a partnership.

A partner does not recognize gain or loss for **current** distributions of money and marketable securities unless the money and/or the FMV of the securities distributed exceed the partner's adjusted partnership basis. Similarly, a partner does not recognize gain in a **liquidating** distribution if the distributed assets do not exceed the partner's adjusted outside basis.

Guaranteed payments to partners may include fringe benefits. These payments are ordinary income and may be offset by the partner's share of the partnership's ordinary loss.

It is the partnership's responsibility to report each partner's share of self-employment (SE) earnings. The distributive shares of income from a partnership are SE earnings for general partners but are not for limited partners. However, guaranteed payments are always SE earnings.

The IRC §179 annual dollar and taxable income limitations apply at **both** the partnership and partner levels. If a partner does not actively or materially participate in the partnership's activities, they cannot claim the §179 deduction from the partnership.

Interest expense associated with the debt-financed acquisition of a partnership interest is allocated based on the assets owned by the partnership or under tracing rules. Partners report such interest expense on either Schedule E or Schedule A, depending on the type of expenditure to which the interest expense is allocated.

Partners must generally include their share of cancellation of debt (COD) income in their gross income. The effect of COD on a partner's basis is described.

A partnership interest is a capital asset. The disposition of the interest results in long- or short-term gain or loss depending on the selling partner's holding period.

Family partnerships are subject to special rules to prevent income-shifting from high-income family partners to low-income family partners. In general, there is no gain or loss on the transfer of a partnership interest by gift but additional rules apply when the partnership interest is gifted or sold to a family partner.

## TAXATION OF PARTNERSHIP INCOME TO PARTNERS

A partnership is treated as a separate entity for purposes of computing income, gains, losses, deductions, and credits for each tax year. However, the partnership entity is generally not subject to income tax. Instead, each partner is taxed on their **distributive share** of partnership income or loss. The distributive share does not typically equal what was actually distributed by the partnership. A partner's share of separately and nonseparately stated items is reported to the partner on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*

The **character** of any item of income, gain, loss, deduction, or credit is determined at the partnership level.<sup>1</sup> Separately stated items are identified on Schedule K-1 or disclosed with the Schedule K-1 (shown on the following pages). **All other nonseparately stated income and deductions from the business operations of the partnership are included in ordinary business income (loss) on Schedule K-1.**

Guaranteed payments are compensation to partners for services or use of capital. These payments are not determined by the partner's share of the partnership's profits. As discussed later in the chapter, guaranteed payments may include certain fringe benefits and may be subject to self-employment taxes.

**Otherwise deductible losses cannot exceed the outside adjusted basis** of the partner's partnership interest at the end of the tax year in which the loss occurs.<sup>2</sup> In addition, losses are subject to the at-risk and passive activity loss rules. All of these limitations are discussed later in the chapter.

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<sup>1</sup> Treas. Reg. §1.702-1(a). See also Schedule K-1 (Form 1065) and related instructions.

<sup>2</sup> IRC §704(d).

**Schedule K-1  
(Form 1065)**Department of the Treasury  
Internal Revenue Service**2016**For calendar year 2016, or tax  
year beginning \_\_\_\_\_, 2016  
ending \_\_\_\_\_, 20\_\_\_\_☐ Final K-1☐ Amended K-1

OMB No. 1545-0123

**Partner's Share of Income, Deductions,  
Credits, etc.**

▶ See back of form and separate instructions.

<b>Part I Information About the Partnership</b>		<b>Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items</b>	
<b>A</b> Partnership's employer identification number		<b>1</b> Ordinary business income (loss)	<b>15</b> Credits
<b>B</b> Partnership's name, address, city, state, and ZIP code		<b>2</b> Net rental real estate income (loss)	
<b>C</b> IRS Center where partnership filed return		<b>3</b> Other net rental income (loss)	<b>16</b> Foreign transactions
<b>D</b> <input type="checkbox"/> Check if this is a publicly traded partnership (PTP)		<b>4</b> Guaranteed payments	
		<b>5</b> Interest income	
		<b>6a</b> Ordinary dividends	
		<b>6b</b> Qualified dividends	
		<b>7</b> Royalties	
		<b>8</b> Net short-term capital gain (loss)	
		<b>9a</b> Net long-term capital gain (loss)	<b>17</b> Alternative minimum tax (AMT) items
		<b>9b</b> Collectibles (28%) gain (loss)	
		<b>9c</b> Unrecaptured section 1250 gain	
		<b>10</b> Net section 1231 gain (loss)	<b>18</b> Tax-exempt income and nondeductible expenses
<b>E</b> Partner's identifying number		<b>11</b> Other income (loss)	
<b>F</b> Partner's name, address, city, state, and ZIP code			
<b>G</b> <input type="checkbox"/> General partner or LLC member-manager <input type="checkbox"/> Limited partner or other LLC member			
<b>H</b> <input type="checkbox"/> Domestic partner <input type="checkbox"/> Foreign partner			
<b>I1</b> What type of entity is this partner? _____			
<b>I2</b> If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here <input type="checkbox"/>			
<b>J</b> Partner's share of profit, loss, and capital (see instructions):		<b>12</b> Section 179 deduction	<b>19</b> Distributions
Beginning Ending		<b>13</b> Other deductions	
Profit % %			<b>20</b> Other information
Loss % %			
Capital % %		<b>14</b> Self-employment earnings (loss)	
<b>K</b> Partner's share of liabilities at year end:			
Nonrecourse . . . . . \$			
Qualified nonrecourse financing . . . \$			
Recourse . . . . . \$			
<b>L</b> Partner's capital account analysis:		*See attached statement for additional information.	
Beginning capital account . . . \$		For IRS Use Only	
Capital contributed during the year . . . \$			
Current year increase (decrease) . . . \$			
Withdrawals & distributions . . . \$ ( )			
Ending capital account . . . . . \$			
<input type="checkbox"/> Tax basis <input type="checkbox"/> GAAP <input type="checkbox"/> Section 704(b) book			
<input type="checkbox"/> Other (explain)			
<b>M</b> Did the partner contribute property with a built-in gain or loss?			
<input type="checkbox"/> Yes <input type="checkbox"/> No			
If "Yes," attach statement (see instructions)			

For Paperwork Reduction Act Notice, see Instructions for Form 1065.

IRS.gov/form1065

Cat. No. 11394R

Schedule K-1 (Form 1065) 2016

**This list identifies the codes used on Schedule K-1 for all partners and provides summarized reporting information for partners who file Form 1040. For detailed reporting and filing information, see the separate Partner's Instructions for Schedule K-1 and the instructions for your income tax return.**

- 1. Ordinary business income (loss).** Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.
 

Passive loss	Report on
Passive income	See the Partner's Instructions
Nonpassive loss	Schedule E, line 28, column (g)
Nonpassive income	Schedule E, line 28, column (h)
- 2. Net rental real estate income (loss)**
- 3. Other net rental income (loss)**

Net income	Schedule E, line 28, column (g)
Net loss	See the Partner's Instructions
- 4. Guaranteed payments**
- 5. Interest income**
- 6a. Ordinary dividends**
- 6b. Qualified dividends**
- 7. Royalties**
- 8. Net short-term capital gain (loss)**
- 9a. Net long-term capital gain (loss)**
- 9b. Collectibles (28%) gain (loss)**
- 9c. Unrecaptured section 1250 gain**
- 10. Net section 1231 gain (loss)**
- 11. Other income (loss)**

Code	
A Other portfolio income (loss)	See the Partner's Instructions
B Involuntary conversions	See the Partner's Instructions
C Sec. 1256 contracts & straddles	Form 6781, line 1
D Mining exploration costs recapture	See Pub. 535
E Cancellation of debt	Form 1040, line 21 or Form 982
F Other income (loss)	See the Partner's Instructions
- 12. Section 179 deduction**
- 13. Other deductions**

A Cash contributions (50%)	See the Partner's Instructions
B Cash contributions (30%)	
C Noncash contributions (50%)	
D Noncash contributions (30%)	
E Capital gain property to a 50% organization (30%)	
F Capital gain property (20%)	
G Contributions (100%)	
H Investment interest expense	Form 4952, line 1
I Deductions—royalty income	Schedule E, line 19
J Section 59(e)(2) expenditures	See the Partner's Instructions
K Deductions—portfolio (2% floor)	Schedule A, line 23
L Deductions—portfolio (other)	Schedule A, line 28
M Amounts paid for medical insurance	Schedule A, line 1 or Form 1040, line 29
N Educational assistance benefits	See the Partner's Instructions
O Dependent care benefits	Form 2441, line 12
P Preproductive period expenses	See the Partner's Instructions
Q Commercial revitalization deduction	
from rental real estate activities	See Form 8582 instructions
R Pensions and IRAs	See the Partner's Instructions
S Reforestation expense deduction	See the Partner's Instructions
T Domestic production activities information	See Form 8903 instructions
U Qualified production activities income	Form 8903, line 7b
V Employer's Form W-2 wages	Form 8903, line 17
W Other deductions	See the Partner's Instructions
- 14. Self-employment earnings (loss)**

**Note:** If you have a section 179 deduction or any partner-level deductions, see the Partner's Instructions before completing Schedule SE.

A Net earnings (loss) from self-employment	Schedule SE, Section A or B
B Gross farming or fishing income	See the Partner's Instructions
C Gross non-farm income	See the Partner's Instructions
- 15. Credits**

A Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	See the Partner's Instructions
B Low-income housing credit (other) from pre-2008 buildings	
C Low-income housing credit (section 42(j)(5)) from post-2007 buildings	
D Low-income housing credit (other) from post-2007 buildings	
E Qualified rehabilitation expenditures (rental real estate)	
F Other rental real estate credits	
G Other rental credits	
H Undistributed capital gains credit	Form 1040, line 73; check box a
I Biofuel producer credit	See the Partner's Instructions
J Work opportunity credit	
K Disabled access credit	

- | Code  | Report on   |
|---|---|
| L Empowerment zone employment credit  | See the Partner's Instructions                                    |
| M Credit for increasing research activities   |   |
| N Credit for employer social security and Medicare taxes                                  |   |
| O Backup withholding  |   |
| P Other credits   |   |
| <b>16. Foreign transactions</b>   |   |
| A Name of country or U.S. possession  | Form 1116, Part I   |
| B Gross income from all sources   |   |
| C Gross income sourced at partner level   |   |
| <i>Foreign gross income sourced at partnership level</i>                                  |   |
| D Passive category  | Form 1116, Part I   |
| E General category  |   |
| F Other   |   |
| <i>Deductions allocated and apportioned at partner level</i>                              |   |
| G Interest expense  | Form 1116, Part I   |
| H Other   | Form 1116, Part I   |
| <i>Deductions allocated and apportioned at partnership level to foreign source income</i> |   |
| I Passive category  | Form 1116, Part I   |
| J General category  |   |
| K Other   |   |
| <i>Other information</i>  |   |
| L Total foreign taxes paid  | Form 1116, Part II  |
| M Total foreign taxes accrued   | Form 1116, Part II  |
| N Reduction in taxes available for credit   | Form 1116, line 12  |
| O Foreign trading gross receipts  | Form 8873   |
| P Extraterritorial income exclusion   | Form 8873   |
| Q Other foreign transactions  | See the Partner's Instructions                                    |
| <b>17. Alternative minimum tax (AMT) items</b>  |   |
| A Post-1986 depreciation adjustment   | See the Partner's Instructions and the Instructions for Form 6251 |
| B Adjusted gain or loss   |   |
| C Depletion (other than oil & gas)  |   |
| D Oil, gas, & geothermal—gross income   |   |
| E Oil, gas, & geothermal—deductions   |   |
| F Other AMT items   |   |
| <b>18. Tax-exempt income and nondeductible expenses</b>                                   |   |
| A Tax-exempt interest income  | Form 1040, line 8b  |
| B Other tax-exempt income   | See the Partner's Instructions                                    |
| C Nondeductible expenses  | See the Partner's Instructions                                    |
| <b>19. Distributions</b>  |   |
| A Cash and marketable securities  | See the Partner's Instructions                                    |
| B Distribution subject to section 737   |   |
| C Other property  |   |
| <b>20. Other information</b>  |   |
| A Investment income   | Form 4952, line 4a  |
| B Investment expenses   | Form 4952, line 5   |
| C Fuel tax credit information   | Form 4136   |
| D Qualified rehabilitation expenditures (other than rental real estate)                   | See the Partner's Instructions                                    |
| E Basis of energy property  | See the Partner's Instructions                                    |
| F Recapture of low-income housing credit (section 42(j)(5))                               | Form 8611, line 8   |
| G Recapture of low-income housing credit (other)  | Form 8611, line 8   |
| H Recapture of investment credit  | See Form 4255   |
| I Recapture of other credits  | See the Partner's Instructions                                    |
| J Look-back interest—completed long-term contracts  | See Form 8697   |
| K Look-back interest—income forecast method   | See Form 8866   |
| L Dispositions of property with section 179 deductions                                    | See the Partner's Instructions                                    |
| M Recapture of section 179 deduction  |   |
| N Interest expense for corporate partners   |   |
| O Section 453(l)(3) information   |   |
| P Section 453A(c) information   |   |
| Q Section 1260(b) information   |   |
| R Interest allocable to production expenditures   |   |
| S CCF nonqualified withdrawals  |   |
| T Depletion information—oil and gas   |   |
| U Reserved  |   |
| V Unrelated business taxable income   |   |
| W Precontribution gain (loss)   |   |
| X Section 108(i) information  |   |
| Y Net investment income   |   |
| Z Other information   |   |

## UNREIMBURSED PARTNERSHIP EXPENSES

A partner may incur out-of-pocket expenses related to a partnership. The partner may only deduct these expenses from gross income when the partnership agreement requires the partner to pay such expenses.<sup>3</sup> Because partners are, by definition, not employees of the partnership, the deduction for out-of-pocket expenses is not subject to the 2% floor for unreimbursed employee expenses.<sup>4</sup>

Unreimbursed expenses are deducted in part II of Schedule E, *Supplemental Income and Loss*. The total deductible expenses are listed separately from other amounts from the partnership and identified using code “UPE.”<sup>5</sup> If the unreimbursed expenses are from an active conduct of a trade or business, then these expenses also reduce the self-employment income on Schedule SE.

## TRANSACTIONS BETWEEN PARTNERS AND THE PARTNERSHIP

A partner may have transactions with the partnership other than as a partner. The general rule is that payments for services performed for a partnership by a partner that are outside their status as a partner are treated in the same manner as between unrelated parties. The same rule holds for the use of capital, sales, and exchanges between a partner and the partnership.<sup>6</sup> However, the following limitations apply.

1. The gain on sales of property other than capital assets by a partner with a more than 50% capital or profits interest, either directly or indirectly, is treated as ordinary income. The term “property other than capital assets” includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.<sup>7</sup> Direct or indirect ownership includes interests of brothers, sisters, spouses, ancestors, and lineal descendants, as well as a share of any partnership interest owned by a corporation, partnership, or trust in which the partner has an interest.<sup>8</sup>
2. Losses on sales or exchanges are disallowed when the sale is between a partner and a partnership in which the partner owns, directly or indirectly, more than a 50% interest.<sup>9</sup>
3. In the case of farm real estate rental arrangements between a managing partner, landlords, and the partnership in which they materially participate, the court and the IRS ruled that rental income from either a crop share or a cash lease is considered self-employment (SE) income for the landlord.<sup>10</sup> The key appears to be that the arrangement designates that the partner is involved to a material degree, through the partnership, in the production and management of agricultural commodities.

**Note.** The 8th Circuit determined that cash rents in these situations are not subject to SE tax if a fair market rent is paid.<sup>11</sup> However, the IRS issued a nonacquiescence on the 8th Circuit decision.

<sup>3</sup> See, e.g., *Johnson v. Comm’r*, TC Memo 1984-598 (Nov. 19, 1984).

<sup>4</sup> Ibid.

<sup>5</sup> Instructions for Schedule E.

<sup>6</sup> IRC §707(a); See also *Heggstad v. Comm’r*, 91 TC 778 (Oct. 17, 1988).

<sup>7</sup> IRC §707(b)(2); See also Treas. Reg. §1.707-1(b)(2). (Regulation does not reflect PL 98-369.)

<sup>8</sup> IRC §707(b)(3); IRC §267(b). See also Treas. Reg. §1.707-1(b)(3). See Rev. Rul. 67-105, 1967-1 CB 167 for an example of a citrus grove sale between related parties.

<sup>9</sup> IRC §707(b)(1); See also Treas. Reg. §1.707-1(b)(1).

<sup>10</sup> *Lee and Pearlene Mizell v. Comm’r*, 70 TCM 1469 (Nov. 29, 1995).

<sup>11</sup> *Bot v. Comm’r*, 78 TCM 220 (Aug. 3, 1999); *Hennen v. Comm’r*, 78 TCM 445 (Sep. 16, 1999); *McNamara v. Comm’r*, 78 TCM 530 (Oct. 4, 1999), *rev’d and rem’d* 236 F.3d 410 (8th Cir. 2000), *nonacq.* IRB 2003-42.

## OUTSIDE BASIS IN PARTNERSHIP INTEREST

### GENERAL BASIS RULE

For income tax purposes, a partnership is treated as owning its assets as a separate entity, and its partners own partnership interests in that entity. This is an application of the **entity rule** of partnership taxation. Under this approach, partners' outside bases in their partnership interest are determined separately from the partnership's inside basis in its assets. This is the origin of the terms **outside basis** and **inside basis**, which refer to partner and partnership bases, respectively.

At the time of the partnership's formation, the total inside bases the partnership has in all of its assets plus its liabilities is equal to the sum of the outside bases of all the partners. This is due to the following requirements.

- A partner's basis in the partnership interest is equal to the partner's basis in contributed assets (increased by any gain recognized under IRC §721(b) for partnerships treated as investment partnerships)<sup>12</sup> plus the partner's share of partnership liabilities.<sup>13</sup>
- The partnership uses a contributing partner's basis as its own basis in the contributed assets plus any gain recognized under IRC §721(b).<sup>14</sup>

Often, such basis equality continues for years because the continuing adjustments made to the inside basis of partnership assets are reflected in the outside bases of the partners.<sup>15</sup>

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<sup>12</sup>. IRC §722.

<sup>13</sup>. IRC §752.

<sup>14</sup>. IRC §723.

<sup>15</sup>. IRC §705.



# 2017 Workbook

**Example 1.** Enid and Fox each contribute \$100 cash to form EF, LLP. The LLP uses \$150 to purchase a rental property. The partnership's initial balance sheet follows.

	Adjusted Basis	Book Value
Asset:		
Cash	\$ 50	\$ 50
Building	<u>150</u>	<u>150</u>
Total	\$200	\$200
Member:		
Enid	\$100	\$100
Fox	<u>100</u>	<u>100</u>
Total	\$200	\$200

During its first year of operation, EF earns \$20 of income, net of expenses other than depreciation, which is \$10. All items are allocated equally between the two members. The LLP has a \$20 increase in cash that has a basis of \$20. It also has a \$10 depreciation deduction that reduces its basis in the building by \$10. These changes to the LLP's inside basis are reflected in the members' changes in their outside bases.

	Adjusted Basis	Book Value
Asset:		
Cash	\$ 70	\$ 70
Building	<u>140</u>	<u>140</u>
Total	\$210	\$210
Member:		
Enid	\$105	\$105
Fox	<u>105</u>	<u>105</u>
Total	\$210	\$210



## Partner's Outside Basis

The correct calculation of a partner's outside basis is necessary for determining:

1. The partner's share of partnership losses that can be deducted,<sup>16</sup>
2. The income tax consequences of distributions of money and property from the partnership,<sup>17</sup> and
3. Gain or loss on a sale or other disposition of the partnership interest.<sup>18</sup>

A partner's original basis in a partnership depends on how it was acquired, as explained for the following situations.

- If the partner acquires the partnership interest in connection with contributions of cash or property to the partnership, the partner's basis is generally the sum of cash and the adjusted basis of assets transferred to the partnership. This is exchanged (or substituted) basis.<sup>19</sup>
- If the partner is required to recognize gain under IRC §721(b) on contributions of securities to an investment partnership, the partner's basis is increased by the gain recognized.<sup>20</sup>
- If the partner acquires the interest by cash purchase, the partner's basis is their cost of such interest.<sup>21</sup>
- If a partnership interest is gifted, the donor's basis carries over to the donee.<sup>22</sup> If the fair market value (FMV) of the gifted interest is less than the donor's basis, the donee's basis for determining loss is the FMV.<sup>23</sup>
- If the partner acquires the interest from a decedent, the basis is the FMV of the partnership interest on the deceased partner's date of death,<sup>24</sup> reduced by the decedent's share of partnership items that would have constituted income in respect of a decedent in the hands of the deceased partner, such as cash receivables.<sup>25</sup>
- A creditor's basis in a partnership interest received in exchange for forgiving a partnership's debt is the lesser of the amount of debt forgiven or the FMV of the interest acquired.<sup>26</sup>
- A partner's basis is increased when the partner assumes partnership liabilities and decreased when the partnership assumes the partner's liabilities.<sup>27</sup> Liabilities treated as assumed by a transferee partner or partnership when transferred property is encumbered are limited to the property's FMV.<sup>28</sup>

**Note.** Liabilities are discussed in detail in the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues.

<sup>16</sup> IRC §704(d).

<sup>17</sup> IRC §§731 and 732.

<sup>18</sup> IRC §§736 and 741.

<sup>19</sup> IRC §722.

<sup>20</sup> Ibid.

<sup>21</sup> IRC §1012.

<sup>22</sup> IRC §1015.

<sup>23</sup> IRC §1015(a).

<sup>24</sup> IRC §1014.

<sup>25</sup> See, e.g., *George Edward Quick Trust v. Comm'r*, 54 TC 1336 (1970), *aff'd per curiam* 444 F.2d 90 (8th Cir. 1971).

<sup>26</sup> IRC §108(e)(8).

<sup>27</sup> IRC §752.

<sup>28</sup> IRC §752(c).

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**Example 2.** Alpha contributes to a partnership in exchange for a partnership interest. His contribution consists of \$10,000 cash, a secured personal note for \$40,000, and property with an FMV of \$20,000 and a basis of \$10,000. Alpha's basis in the partnership interest and capital account are as follows.

Asset	Basis	FMV
Cash	\$10,000	\$10,000
Secured note	0	40,000
Property	10,000	20,000
Total	\$20,000	\$70,000

After a partner's initial basis is determined, it is continually adjusted as follows.

**1.** Basis is **increased** by the following items.

- Additional contributions of cash and basis of property contributed to the partnership and allocation of additional partnership liabilities<sup>29</sup>
- The partner's distributive share of nonseparately computed and separately stated income<sup>30</sup>
- The partner's distributive share of partnership tax-exempt income<sup>31</sup>
- The partner's distributive share of the excess of the deductions for depletion over the partner's share of the partnership's basis in the property<sup>32</sup>

**2.** Basis is **decreased**, but not below zero, by the following items.<sup>33</sup>

- The amount of money and the adjusted basis of property distributed to the partner by the partnership, including money attributable to a partner's reduction in partnership liabilities allocated to the partner<sup>34</sup>
- The partner's distributive share of separately and nonseparately stated partnership losses, including capital losses
- The partner's distributive share of nondeductible partnership expenses that are not capital expenditures
- The amount of the partner's deduction for depletion for any partnership oil and gas wells, up to the partner's proportionate share of the partnership's adjusted basis for such properties

Partners generally determine the basis of their partnership interests at the end of the partnership's tax year. It may be necessary to compute a partner's basis during the partnership's tax year rather than at the end of the year, however, if:

- The partnership tax year closes for a partner because of a sale or liquidation of the partner's entire partnership interest,<sup>35</sup> or
- A partner receives a distribution of cash from the partnership in excess of their partnership basis (rather than a draw).<sup>36</sup>

<sup>29</sup> Treas. Reg. §1.722-1.

<sup>30</sup> IRC §705(a)(1)(A).

<sup>31</sup> IRC §705(a)(1)(B).

<sup>32</sup> IRC §705(a)(1)(C).

<sup>33</sup> IRC §§705(a)(2) and (3).

<sup>34</sup> IRC §733.

<sup>35</sup> IRC §706(c)(2)(A).

<sup>36</sup> IRC §731(a)(1).

As mentioned earlier, if a partner inherits a partnership interest from a decedent and the interest is included in the decedent's gross estate, the basis is equal to the partnership interest's FMV on the decedent's date of death.<sup>37</sup> The FMV basis then must be reduced by the deceased partner's share of any items of the partnership on the decedent partner's date of death which, had the deceased partner held them directly, would have been income in respect of a decedent (IRD) in the hands of the deceased partner.<sup>38</sup>

**Note.** It is therefore necessary for anyone acquiring a partnership interest from a decedent to know, on the decedent's date of death, all items of the partnership that would have been IRD if the decedent had held them directly. This includes such things as cash basis accounts receivable of the partnership and rental crop shares. It also includes gain on the disposition of any asset which, on the decedent's date of death, the partnership had contracted to sell and for which there were no material contingencies remaining unsatisfied at the time of the decedent's death. This information should be reported by the partnership on the deceased partner's Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, as supplementary information.

**Example 3.** Frances was a 50% partner in a cash basis partnership before her death. The FMV of the partnership interest is \$50. The partnership assets include a \$20 account receivable, of which \$10 is Frances's share. Because the \$10 would have constituted IRD if held directly by Frances, the outside partnership basis must be reduced by \$10, from \$50 to \$40. When the receivable is actually collected and passed through to Frances's successor, the outside partnership basis will increase from \$40 to \$50. A liquidation of Frances's interest for \$50 would therefore result in no gain or loss.

Without the outside basis reduction, collection of the receivable would increase the partnership basis from \$50 to \$60. Redemption of the partnership interest for its \$50 FMV therefore would result in a \$10 loss, offsetting the effect of the \$10 of IRD (although the loss would be a capital loss and the IRD would be ordinary income).

## LIABILITIES' EFFECT ON BASIS

A partner's outside basis is adjusted for increases and decreases in their proportionate share of any debt owed by the partnership. Additional liabilities increase basis while reductions in liabilities reduce basis. The partnership is responsible for reporting the partner's share of liabilities on Schedule K-1 in part II, section K.

**Note.** For a comprehensive discussion of the allocation of partnership liabilities to the partners, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues.

<sup>37</sup> IRC §1014.

<sup>38</sup> IRC §1014(c). See, e.g., *George Edward Quick Trust v. Comm'r*, 54 TC 1336 (1970), *aff'd per curiam* 444 F.2d 90 (8th Cir. 1971).

## THE THREE LOSS LIMITATIONS

Three different sets of rules may limit the amount of losses deductible by a partner in a partnership. These limitations, **in the order in which they are applied**, are as follows.

1. The **basis** limitation under IRC §704
2. The **at-risk** rules under IRC §465
3. The **passive activity loss** rules under IRC §469

### BASIS

A partner's distributive share of aggregate business losses and separately stated items may exceed the partner's outside basis. If this occurs, the overall limitation on losses<sup>39</sup> must be allocated to the partner's distributive share of **each** loss.<sup>40</sup> This allocation is made based on the proportion that each loss bears to the total of all losses.<sup>41</sup> However, for this purpose, the total losses for the tax year are the sum of the partner's distributive share of losses for the current year, as well as any losses disallowed and carried forward from prior years.<sup>42</sup> Disallowed losses for the current year are carried forward to subsequent tax years.<sup>43</sup>

**Example 4.** At the beginning of 2016, Adam had a \$3,000 basis in his partnership interest. Adam's Schedule K-1 for 2016 shows the following.

Ordinary business income	\$4,000
Short-term capital loss	(5,000)
IRC §1231 loss	(9,000)

Adam's beginning basis was increased by his share of ordinary business income. Therefore, his adjusted basis before losses was \$7,000 (\$3,000 + \$4,000). Adam's share of the losses was \$14,000 (\$5,000 + \$9,000). Because Adam's share of losses exceeded his basis, he prorated the losses as shown in the following table.

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

Guaranteed payments to a partner do not affect basis. Accordingly, even if a partner has taxable income from the partnership due to the receipt of guaranteed payments, any losses are still subject to the basis limitations.<sup>44</sup>

<sup>39</sup> IRC §704(d).

<sup>40</sup> Treas. Reg. §1.704-1(d)(2).

<sup>41</sup> Ibid.

<sup>42</sup> Ibid.

<sup>43</sup> Treas. Reg. §1.704-1(d)(1).

<sup>44</sup> IRS Pub. 541, *Partnerships*.

**Example 5.** At the beginning of 2016, Eve had a zero basis in her partnership interest. Her Schedule K-1 for 2016 shows the following.

Ordinary business loss	(\$6,000)
Guaranteed payments	10,000

Eve could not claim the loss on her 2016 return because it exceeded her basis. The \$6,000 loss was carried forward to 2017. However, Eve was still required to report the \$10,000 of guaranteed payments as ordinary income for 2016.

Gains upon liquidation or disposition of a partnership interest do not increase basis. Therefore, any losses carried forward due to basis limitations are not allowed upon disposition of the interest. This is logical, because the partner did not incur an economic loss from the disallowed losses.

### AT-RISK RULES

The at-risk rules are a possible limitation on each partner's ability to deduct a pass-through loss from the partnership even when the losses are not limited by the basis rules.

The at-risk rules cover any trade or business or income-producing activity. Under the at-risk rules, a partner can only claim a loss up to the amount for which they are at risk. The partner is at risk for the following.

1. The amount of money plus the adjusted basis of property contributed to the partnership
2. The amounts the partner borrowed for use in the partnership activity as long as the partner is either:
  - a. Personally liable for repayment, or
  - b. The partner pledged property as security for the debt.

Certain debts do not increase **basis** under the at-risk rules.<sup>45</sup> In most cases, nonrecourse debts or debts with a guarantee or stop-loss provision are not considered to place the member in additional risk and therefore do not increase basis for the partner.

Prop. Treas. Reg. §1.465-1 indicates that the appropriate time to calculate at-risk basis is at the end of the tax year for the business entity. In addition, this proposed regulation also notes that in applying the at-risk rules, "...substance will prevail over form. Regardless of the form a transaction may take, the taxpayer's amount at risk will not be increased if the transaction is inconsistent with normal commercial practices or is, in essence, a device to avoid section 465."

<sup>45</sup> Amounts borrowed from persons (or their relatives) having an interest in the business activity do not qualify, with some exceptions. See IRC §465(b)(3).

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**Example 6.** In 2015, Charlie and Deborah establish their new partnership, C & D Design. During 2015, Charlie contributes various assets with a \$40,000 FMV and a cost basis of \$30,000, plus \$80,000 cash. Of this cash contribution, \$70,000 was a bank loan guaranteed by Charlie's mother. Deborah contributed assets with a \$60,000 FMV and a basis of \$40,000, plus \$60,000 cash from a mortgage loan secured by her home. Charlie and Deborah are equal owners of the partnership. For 2015, the partnership reports a \$100,000 loss. No other contributions were made by either partner to the partnership during the year.

Charlie's and Deborah's basis amounts for the end of the 2015 tax year under the at-risk rules are calculated as follows.

	Charlie	Deborah
Cash	\$10,000	\$ 0
Asset basis	30,000	40,000
Qualifying debt	0	60,000
Total basis under at-risk rules	\$40,000	\$100,000

Because Charlie's debt had a guarantee, it does not provide him with basis under the at-risk rules. Conversely, Deborah's mortgage loan, for which she pledged her home as security, provides her with additional basis under the at-risk rules.

The \$100,000 loss for 2015 is shared equally by Charlie and Deborah, providing them each with an allocated loss of \$50,000. This is reported on each of their respective Schedules K-1. Charlie can only claim the loss up to the amount of his \$40,000 basis for the year. Because he only has \$40,000 at risk in the business endeavor, the at-risk rules limit the amount of loss he can claim. Accordingly, he claims \$40,000 of the \$50,000 loss in 2015. The excess loss of \$10,000 is a **suspended loss**<sup>46</sup> that carries forward to 2016 and can be claimed in 2016 or a future year only if and when Charlie has sufficient basis.

Deborah has more than enough basis (\$100,000) to deduct her \$50,000 share of the loss for 2015.

## Adjustment to the Partner's At-Risk Amount

Each partner's at-risk amount is adjusted annually. It is increased by the additional amount of money or property basis and qualified debt contributed to the business. At-risk basis is also increased by the partner's share of partnership income. It is reduced by losses allowed in prior years under the at-risk rules and by the amount of distributions made by the partnership. The at-risk amount is reduced if previously qualifying debt subsequently becomes unqualified. This could occur if someone else guarantees the debt or if the debt becomes nonrecourse. Conversely, when debt that previously did not qualify as basis is changed and becomes qualified, the debt increases basis.

**Note.** Form 6198, *At-Risk Limitations*, is used to calculate the amounts at risk and determine the amount of deductible losses for the current tax year.

<sup>46</sup> IRC §465(a)(2).

**Example 7.** Use the same facts as **Example 6**. During 2016, Charlie’s mother removes her guarantee on his loan and Deborah contributes an additional \$10,000 of cash to the business.

For the beginning of 2016, adjustments to the basis figures for Charlie and Deborah are made to reflect the changes that occurred in 2015. To arrive at the correct basis figures for each partner for 2016, each partner’s basis is reduced by the amounts of their respective losses that were allowed in 2015 under the at-risk rules. Moreover, for changes occurring during 2016, Charlie’s loan no longer has a guarantee. Therefore, it qualifies as additional basis under the at-risk rules. Similarly, Deborah’s additional cash contribution qualifies as additional basis for her. The adjustments are as follows.

	Charlie	Deborah
2015 beginning basis	\$40,000	\$100,000
Less: 2015 losses allowed	(40,000)	(50,000)
Subtotal	\$ 0	\$ 50,000
Plus: additional cash, property basis, or qualified debt during 2016	70,000	10,000
2016 ending basis	\$70,000	\$ 60,000

**Example 8.** Use the same facts as **Example 7**. C & D Design has a 2016 loss of \$60,000. Charlie and Deborah equally share the loss — \$30,000 each.

For 2016, Charlie has enough basis (\$70,000) to claim the \$10,000 suspended loss from 2015 in addition to the full amount of his \$30,000 share of the loss for 2016. His total allowed loss in 2016 is \$40,000. Likewise, Deborah’s \$60,000 basis is enough for her to claim her \$30,000 loss for 2016.

For the start of 2017, Charlie’s basis under the at-risk rules is his \$70,000 basis at the end of 2016 minus the total losses (\$40,000) allowed for 2016. His basis is \$30,000 (\$70,000 – \$40,000) at the beginning of 2017. This subsequently is adjusted for any additional increases or decreases applicable during 2017 to arrive at the basis figure for the end of 2017.

Similarly, Deborah’s at-risk basis at the beginning of 2017 is her \$60,000 basis for 2016 less the allowed \$30,000 loss. Her adjusted at-risk basis is \$30,000. This is adjusted at the end of 2017 for any applicable changes for activities having an impact on at-risk basis during 2017.



## At-Risk Recapture

When a partner's at-risk amount is negative for the tax year, they must recapture at least a portion of the losses previously allowed. This is accomplished by increasing the year's income from the partnership by the lesser of:

- The negative at-risk amount (expressed as a positive income amount), or
- The total amount of losses deducted in previous tax years minus any amounts previously added to income under this recapture rule.

**Example 9.** Use the same facts as in **Example 8**. During the 2017 tax year, Charlie's mother again agrees to place a guarantee on his loan, which is still \$70,000. The partnership reports a loss of \$10,000, which is split equally between Charlie and Deborah.

Charlie and Deborah claimed the following allowed losses under the at-risk rules for 2015 and 2016.

	Charlie	Deborah
2015 loss claimed	\$40,000	\$50,000
2016 loss claimed	40,000	30,000
Total prior year losses	\$80,000	\$80,000

Charlie's basis under the at-risk rules as at the end of 2017 is as follows.

2017 beginning basis	\$30,000
Reduction in basis due to renewed debt guarantee	(70,000)
2017 ending basis	(\$40,000)

Charlie's basis has become negative. This triggers **recapture** of at least part of the \$80,000 of losses he claimed in prior years. The amount to recapture is the **lesser of**:

- The negative at-risk amount, expressed as a positive number (**\$40,000**), or
- The total amount of losses deducted in previous tax years minus any amounts previously added to income under the recapture rule (**\$80,000**).

Therefore, the amount recaptured is \$40,000. Charlie must report an additional \$40,000 of ordinary income for 2017. The recaptured \$40,000 becomes a suspended carryforward loss for Charlie. He and Deborah split the \$10,000 loss for 2017 equally. For Charlie, this \$5,000 loss adds to the \$40,000 suspended loss that carries forward to 2018 and future years. It can be claimed against future basis increases. Deborah already has sufficient basis for 2017 (\$30,000) to claim her \$5,000 loss.

## PASSIVE LOSS<sup>47</sup>

In addition to complying with basis requirements and at-risk rules, losses from a partnership are subject to the passive loss limitations. Passive activities include all trades or businesses in which the taxpayer does **not materially participate**, as well as most rental activities. Certain limited exceptions apply for real estate professionals.<sup>48</sup>

In general, under the passive loss rules, a loss or credit from a passive activity may **only be used to the extent the taxpayer has income from a passive activity**. If passive activity losses exceed a taxpayer's passive activity income, the losses are suspended until the taxpayer has sufficient income from the activity giving rise to the passive loss or from some other passive activity. The losses also cease to be suspended when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction.

**Note.** Any losses suspended under the passive loss rules should be listed on Form 8582, *Passive Activity Loss Limitations*.

## Material Participation

An individual partner **materially participates** in an activity during a tax year if the partner meets one of the following tests.<sup>49</sup>

1. The individual participates for **more than 500 hours**.
2. The individual's participation in the activity **constitutes substantially all of the participation** in such activity by all of the participants (including nonpartners).
3. The individual participates in the activity for **more than 100 hours** and no other individual participates in the activity more than the individual.
4. The activity is a **significant participation activity** and the individual's aggregate participation in all significant participation activities exceeds 500 hours.
5. The individual materially participated in the activity for **five of the preceding 10 tax years** (regardless of whether they were consecutive).
6. The activity is a **personal service activity** and the individual materially participated in any **three preceding years** (regardless of whether they were consecutive).
7. Based on the facts and circumstances, the individual **participates on a regular, continuous, and substantial basis**.<sup>50</sup>

<sup>47</sup> IRC §469.

<sup>48</sup> IRC §469(c)(7).

<sup>49</sup> Temp. Treas. Reg. §1.469-5T.

<sup>50</sup> IRC §469(h)(1). See also *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Or. 2001).

## Limited Partners

Under IRC §469(h)(2), limited partners do not qualify as materially participating in their partnership's activities except as allowed under the regulations. The same restriction applies to the active participation tests for rental real estate activities.<sup>51</sup>

The regulations provide an exception for a limited partner who satisfies test 1, 5, or 6 for material participation.<sup>52</sup> In addition, these regulations provide that if a limited partner is also a general partner, the limited partnership interest is treated as a general partnership interest.<sup>53</sup> These provisions apply to limited partnerships (LPs) that must have at least one general partner and at least one limited partner.<sup>54</sup>

It was initially the IRS's position that because of their limited liability under state law, members of LLCs and LLPs (limited liability partnerships) were limited partners for purposes of determining material participation. However, both the Tax Court and the Court of Federal Claims have held that LLC and LLP members' interests are not IRC §469(h)(2) limited partnership interests subject to the more stringent test for material participation under the passive activity rules. This is because both LLC members and LLP partners can be treated as "general partners" under state laws.<sup>55</sup> Members of LLCs and LLPs are therefore entitled to use all seven material participation tests.

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<sup>51</sup> IRC §469(i)(6)(C).

<sup>52</sup> Temp. Treas. Reg. §1.469-5T(e)(2).

<sup>53</sup> Temp. Treas. Reg. §1.469-5T(e)(3)(ii).

<sup>54</sup> Revised Uniform Limited Partnership Act.

<sup>55</sup> *Thompson v. U.S.*, 87 Fed. Cl. 728 (Fed. Cl. 2009); *Garnett v. Comm'r*, 132 TC No. 19 (2009).

## COMPREHENSIVE EXAMPLE OF THE THREE LOSS LIMITATIONS

To determine whether a Schedule K-1 loss is deductible, the following **three steps** are applied in order.

- Step 1.** Determine the partner's basis in their ownership interest.
- Step 2.** Ascertain what amount, if any, of this initial basis is considered at risk.
- Step 3.** Determine whether the passive loss rules apply, and limit the loss to any passive income.

**Example 10.** In 2015, Ben contributed \$10,000 cash to J&B, LLC, and received a 50% interest in return. The LLC is taxed as a partnership. Ben also loaned \$40,000 to the LLC. In 2015, J&B borrowed \$60,000 to purchase equipment without any of the partners guaranteeing the debt. Ben did not materially participate in the business operations.

Ben also realized \$30,000 from the sale of a rental property that is characterized as passive income. He actively participated in the rental property activity.

The partnership incurred a loss for 2015. Ben's distributive share of the loss was **\$100,000**. The partnership did not make any distributions in 2015. Ben's 2015 Form 6198, Form 8582, and page 2 of Schedule E follow the explanations of the three steps.

**Step 1.** What was Ben's basis before considering the loss?

Ben's initial basis was calculated as follows.

Cash contributed	\$10,000
Personal loan to partnership	40,000
Allocable share of the partnership's nonrecourse debt (50% of \$60,000)	<u>30,000</u>
Total initial basis	<u>\$80,000</u>

Ben's \$80,000 basis was insufficient to deduct the entire \$100,000 loss. Therefore, \$20,000 of the loss (\$100,000 – \$80,000) was suspended due to lack of basis. The remaining \$80,000 loss was subject to at-risk and passive loss limitations.

**Note.** There is no IRS form or schedule to report losses suspended due to the basis limitations. On Ben's 2015 Form 6198, shown later, line 1 shows the \$80,000 loss allowable after the basis limitation.

**Step 2.** What was Ben's at-risk amount?

Ben bore no economic risk of loss for his \$30,000 share of the LLC's nonrecourse debt. Consequently, even if the partnership failed to pay this debt, Ben would not be personally liable for its repayment. Therefore, of Ben's \$80,000 basis (Step 1), only \$50,000 is considered at risk. Accordingly, \$30,000 of the \$80,000 loss (as allowed under the basis rules) was suspended under the at-risk rules.

**Step 3.** How do the **passive loss** rules limit the deduction of the \$50,000 loss from **Step 2**?

Because Ben had \$30,000 of passive income from other sources, \$30,000 of the \$50,000 loss (as allowed after applying the basis and the at-risk rules) was deductible. The remaining \$20,000 loss was suspended under the passive activity rules.

# 2017 Workbook

## For Example 10

Form **6198**

(Rev. November 2009)  
Department of the Treasury  
Internal Revenue Service

### At-Risk Limitations

- **Attach to your tax return.**  
► **See separate instructions.**

OMB No. 1545-0712

Attachment  
Sequence No. **31**

Name(s) shown on return

**Ben**

Identifying number

**123-12-3123**

Description of activity (see page 2 of the instructions)

**Partnership Schedule K-1 J&B, LLC 12-0123123**

#### **Part I Current Year Profit (Loss) From the Activity, Including Prior Year Nondeductible Amounts.**

See page 2 of the instructions.

<b>1</b>	Ordinary income (loss) from the activity (see page 2 of the instructions)	<b>1</b>	<b>(80,000)</b>
<b>2</b>	Gain (loss) from the sale or other disposition of assets used in the activity (or of your interest in the activity) that you are reporting on:		
<b>a</b>	Schedule D	<b>2a</b>	
<b>b</b>	Form 4797	<b>2b</b>	
<b>c</b>	Other form or schedule	<b>2c</b>	
<b>3</b>	Other income and gains from the activity, from Schedule K-1 of Form 1065, Form 1065-B, or Form 1120S, that were not included on lines 1 through 2c	<b>3</b>	
<b>4</b>	Other deductions and losses from the activity, including investment interest expense allowed from Form 4952, that were not included on lines 1 through 2c	<b>4</b>	( )
<b>5</b>	Current year profit (loss) from the activity. Combine lines 1 through 4. See page 3 of the instructions before completing the rest of this form	<b>5</b>	<b>(80,000)</b>

#### **Part II Simplified Computation of Amount At Risk.** See page 3 of the instructions before completing this part.

<b>6</b>	Adjusted basis (as defined in section 1011) in the activity (or in your interest in the activity) on the first day of the tax year. <b>Do not</b> enter less than zero	<b>6</b>	<b>50,000</b>
<b>7</b>	Increases for the tax year (see page 3 of the instructions)	<b>7</b>	
<b>8</b>	Add lines 6 and 7	<b>8</b>	<b>50,000</b>
<b>9</b>	Decreases for the tax year (see page 4 of the instructions)	<b>9</b>	
<b>10a</b>	Subtract line 9 from line 8	<b>10a</b>	<b>50,000</b>
<b>b</b>	If line 10a is <b>more</b> than zero, enter that amount here and go to line 20 (or complete Part III). Otherwise, enter -0- and see <b>Pub. 925</b> for information on the recapture rules	<b>10b</b>	<b>50,000</b>

#### **Part III Detailed Computation of Amount At Risk.** If you completed Part III of Form 6198 for the prior year, see page 4 of the instructions.

<b>11</b>	Investment in the activity (or in your interest in the activity) at the effective date. <b>Do not</b> enter less than zero	<b>11</b>	
<b>12</b>	Increases at effective date	<b>12</b>	
<b>13</b>	Add lines 11 and 12	<b>13</b>	
<b>14</b>	Decreases at effective date	<b>14</b>	
<b>15</b>	Amount at risk (check box that applies):	<b>15</b>	
<b>a</b>	<input type="checkbox"/> At effective date. Subtract line 14 from line 13. <b>Do not</b> enter less than zero.		
<b>b</b>	<input type="checkbox"/> From your prior year Form 6198, line 19b. <b>Do not</b> enter the amount from line 10b of your prior year form.		
<b>16</b>	Increases since (check box that applies):	<b>16</b>	
<b>a</b>	<input type="checkbox"/> Effective date	<b>b</b>	<input type="checkbox"/> The end of your prior year
<b>17</b>	Add lines 15 and 16	<b>17</b>	
<b>18</b>	Decreases since (check box that applies):	<b>18</b>	
<b>a</b>	<input type="checkbox"/> Effective date	<b>b</b>	<input type="checkbox"/> The end of your prior year
<b>19a</b>	Subtract line 18 from line 17	<b>19a</b>	
<b>b</b>	If line 19a is <b>more</b> than zero, enter that amount here and go to line 20. Otherwise, enter -0- and see <b>Pub. 925</b> for information on the recapture rules	<b>19b</b>	

#### **Part IV Deductible Loss**

<b>20</b>	<b>Amount at risk.</b> Enter the <b>larger</b> of line 10b or line 19b	<b>20</b>	<b>50,000</b>
<b>21</b>	<b>Deductible loss.</b> Enter the <b>smaller</b> of the line 5 loss (treated as a positive number) or line 20. See page 8 of the instructions to find out how to report any deductible loss and any carryover	<b>21</b>	<b>( 50,000 )</b>

**Note:** If the loss is from a passive activity, see the Instructions for **Form 8582**, *Passive Activity Loss Limitations*, or the Instructions for **Form 8810**, *Corporate Passive Activity Loss and Credit Limitations*, to find out if the loss is allowed under the passive activity rules. If only part of the loss is subject to the passive activity loss rules, report only that part on Form 8582 or Form 8810, whichever applies.

For Paperwork Reduction Act Notice, see page 8 of the instructions.

Cat. No. 50012Y

Form **6198** (Rev. 11-2009)

## For Example 10

<b>Form 8582</b> Department of the Treasury Internal Revenue Service (99)	<b>Passive Activity Loss Limitations</b> ▶ See separate instructions. ▶ Attach to Form 1040 or Form 1041. ▶ Information about Form 8582 and its instructions is available at <a href="http://www.irs.gov/form8582">www.irs.gov/form8582</a> .	OMB No. 1545-1008 <b>2015</b> Attachment Sequence No. <b>88</b>
Name(s) shown on return <b>Ben</b>		Identifying number <b>123-12-3123</b>
<b>Part I 2015 Passive Activity Loss</b> <b>Caution:</b> Complete Worksheets 1, 2, and 3 before completing Part I.		
<b>Rental Real Estate Activities With Active Participation</b> (For the definition of active participation, see Special Allowance for Rental Real Estate Activities in the instructions.)		
<b>1a</b> Activities with net income (enter the amount from Worksheet 1, column (a)) . . . . .	<b>1a</b>	<b>30,000</b>
<b>b</b> Activities with net loss (enter the amount from Worksheet 1, column (b)) . . . . .	<b>1b</b> (                      0                      )	
<b>c</b> Prior years unallowed losses (enter the amount from Worksheet 1, column (c)) . . . . .	<b>1c</b> (                                           )	
<b>d</b> Combine lines 1a, 1b, and 1c . . . . .	<b>1d</b>	<b>30,000</b>
<b>Commercial Revitalization Deductions From Rental Real Estate Activities</b>		
<b>2a</b> Commercial revitalization deductions from Worksheet 2, column (a) . . . . .	<b>2a</b> (                                           )	
<b>b</b> Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b) . . . . .	<b>2b</b> (                                           )	
<b>c</b> Add lines 2a and 2b . . . . .	<b>2c</b> (                                           )	
<b>All Other Passive Activities</b>		
<b>3a</b> Activities with net income (enter the amount from Worksheet 3, column (a)) . . . . .	<b>3a</b>	<b>0</b>
<b>b</b> Activities with net loss (enter the amount from Worksheet 3, column (b)) . . . . .	<b>3b</b> (                      50,000                      )	
<b>c</b> Prior years unallowed losses (enter the amount from Worksheet 3, column (c)) . . . . .	<b>3c</b> (                                           )	
<b>d</b> Combine lines 3a, 3b, and 3c . . . . .	<b>3d</b>	<b>(50,000)</b>
<b>4</b> Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used . . . . . If line 4 is a loss and: <ul style="list-style-type: none"> <li>• Line 1d is a loss, go to Part II.</li> <li>• Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.</li> <li>• Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.</li> </ul>	<b>4</b>	<b>(20,000)</b>
<b>Caution:</b> If your filing status is married filing separately and you lived with your spouse at any time during the year, <b>do not</b> complete Part II or Part III. Instead, go to line 15.		
<b>Part II Special Allowance for Rental Real Estate Activities With Active Participation</b> <b>Note:</b> Enter all numbers in Part II as positive amounts. See instructions for an example.		
<b>5</b> Enter the <b>smaller</b> of the loss on line 1d or the loss on line 4 . . . . .	<b>5</b>	
<b>6</b> Enter \$150,000. If married filing separately, see instructions . . . . .	<b>6</b>	
<b>7</b> Enter modified adjusted gross income, but not less than zero (see instructions) <b>Note:</b> If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.	<b>7</b>	
<b>8</b> Subtract line 7 from line 6 . . . . .	<b>8</b>	
<b>9</b> Multiply line 8 by 50% (.5). <b>Do not</b> enter more than \$25,000. If married filing separately, see instructions	<b>9</b>	
<b>10</b> Enter the <b>smaller</b> of line 5 or line 9 . . . . . If line 2c is a loss, go to Part III. Otherwise, go to line 15.	<b>10</b>	
<b>Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities</b> <b>Note:</b> Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.		
<b>11</b> Enter \$25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	<b>11</b>	
<b>12</b> Enter the loss from line 4 . . . . .	<b>12</b>	
<b>13</b> Reduce line 12 by the amount on line 10 . . . . .	<b>13</b>	
<b>14</b> Enter the <b>smallest</b> of line 2c (treated as a positive amount), line 11, or line 13 . . . . .	<b>14</b>	
<b>Part IV Total Losses Allowed</b>		
<b>15</b> Add the income, if any, on lines 1a and 3a and enter the total . . . . .	<b>15</b>	<b>30,000</b>
<b>16</b> <b>Total losses allowed from all passive activities for 2015.</b> Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return . . . . .	<b>16</b>	<b>30,000</b>

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 63704F

Form **8582** (2015)

# 2017 Workbook

## For Example 10

Form 8582 (2015)

Page **2**

**Caution:** The worksheets must be filed with your tax return. Keep a copy for your records.

**Worksheet 1—For Form 8582, Lines 1a, 1b, and 1c** (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
Residential Rental	30,000	0		30,000	
Total. Enter on Form 8582, lines 1a, 1b, and 1c	30,000	0			

**Worksheet 2—For Form 8582, Lines 2a and 2b** (See instructions.)

Name of activity	(a) Current year deductions (line 2a)	(b) Prior year unallowed deductions (line 2b)	(c) Overall loss
Total. Enter on Form 8582, lines 2a and 2b			

**Worksheet 3—For Form 8582, Lines 3a, 3b, and 3c** (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 3a)	(b) Net loss (line 3b)	(c) Unallowed loss (line 3c)	(d) Gain	(e) Loss
J&B, LLC	0	50,000			50,000
Total. Enter on Form 8582, lines 3a, 3b, and 3c	0	50,000			

**Worksheet 4—Use this worksheet if an amount is shown on Form 8582, line 10 or 14** (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
Total			1.00		

**Worksheet 5—Allocation of Unallowed Losses** (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
J&B, LLC	E Ln 28A	50,000	1.00	20,000
Total		50,000	1.00	20,000

Form **8582** (2015)



# 2017 Workbook

## For Example 10

Form 8582 (2015)

Page **3**

### Worksheet 6— Allowed Losses (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Unallowed loss	(c) Allowed loss
J&B, LLC	E Ln 28A	50,000	20,000	30,000
<b>Total</b>		<b>50,000</b>	<b>20,000</b>	<b>30,000</b>

### Worksheet 7— Activities With Losses Reported on Two or More Forms or Schedules (See instructions.)

Schedule E (Form 1040) 2015

Attachment Sequence No. **13**

Page **2**

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

Your social security number

**Ben**

**123-12-3123**

**Caution.** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II Income or Loss From Partnerships and S Corporations** **Note:** If you report a loss from an at-risk activity for which any amount is **not** at risk, you **must** check the box in column (e) on line 28 and attach **Form 6198**. See instructions.

**27** Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section. ☐ **Yes** ☒ **No**

<b>28</b>	(a) Name	(b) Enter <b>P</b> for partnership; <b>S</b> for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
<b>A</b>	J&B, LLC	<b>P</b>	<input type="checkbox"/>	<b>12-0123123</b>	<input checked="" type="checkbox"/>
<b>B</b>			<input type="checkbox"/>		<input type="checkbox"/>
<b>C</b>			<input type="checkbox"/>		<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>

Passive Income and Loss			Nonpassive Income and Loss		
(f) Passive loss allowed (attach <b>Form 8582</b> if required)	(g) Passive income from <b>Schedule K-1</b>		(h) Nonpassive loss from <b>Schedule K-1</b>	(i) Section 179 expense deduction from <b>Form 4562</b>	(j) Nonpassive income from <b>Schedule K-1</b>
<b>A</b> 30,000					
<b>B</b>					
<b>C</b>					
<b>D</b>					
<b>29a Totals</b>					
<b>b Totals</b> 30,000					
<b>30</b> Add columns (g) and (j) of line 29a				<b>30</b>	
<b>31</b> Add columns (f), (h), and (i) of line 29b				<b>31</b> ( 30,000 )	
<b>32 Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31. Enter the result here and include in the total on line 41 below				<b>32</b> (30,000)	

### Part III Income or Loss From Estates and Trusts

Summary of results for **Example 10**:

Applicable Limitation	Losses Suspended By the Applicable Limitation
Basis	\$20,000
At-risk	30,000
Passive activity	20,000
Total suspended losses	\$70,000

# 2017 Workbook

**Example 11.** Use the same facts as **Example 10**. In 2016, Ben's share of the LLC's net income was \$50,000. Ben continued to hold this interest strictly as an investment and did not materially participate in the business. He had no rental properties in 2016 and had no other net passive income for the year. There was no change in the company's debt. Ben's 2016 Form 8582 and Schedule E, page 2, follow the explanations of the three steps.

**Step 1.** Ben's basis of zero from 2015 was increased to \$50,000 by his share of the partnership's net income. The \$20,000 of suspended loss due to basis limitations from 2015 was allowed on his 2016 return. His ending basis for 2016 was calculated as follows.

Basis at the beginning of 2016	\$ 0
2016 LLC income	<u>50,000</u>
Initial basis for 2016	\$50,000
2015 loss suspended due to lack of basis	<u>(20,000)</u>
Basis at the end of 2016	\$30,000

**Step 2.** The \$50,000 of net income increased Ben's at-risk amount. The \$30,000 of losses suspended due to the at-risk limitations from 2015 was allowed on his 2016 return. His ending at-risk basis for 2016 was calculated as follows.

Basis at risk at the beginning of 2016	\$ 0
2016 LLC income	<u>50,000</u>
Initial at-risk basis for 2016	\$50,000
2015 loss suspended due to at-risk rules	<u>(30,000)</u>
Basis at risk at the end of 2016	\$20,000

**Note.** To calculate the amount reported on line 1 of **Form 6198**, Ben subtracted his \$20,000 carryforward loss allowed in 2016 (as calculated in **Step 1 for basis**) from his \$50,000 of 2016 income to arrive at his 2016 net income of \$30,000. Then, in accordance with the instructions for Form 6198, he combined his prior loss of \$30,000 (that was suspended in 2015 due to the at-risk rules) with the 2016 net income. Accordingly, he entered zero on line 1 of his Form 6198. He reported no other amounts on Form 6198 (not shown).

**Step 3.** The \$50,000 of Schedule K-1 income was passive. However, this income did not release any of the \$20,000 suspended passive loss from 2015 because all of the 2016 income was absorbed by the suspended basis and at-risk losses. Therefore, the \$20,000 suspended passive loss from 2015 continued to be suspended and was carried forward to 2017.

The following selected forms and schedules from Ben's 2016 return show how the loss was reported. Note that the \$50,000 of released losses from 2015 were not combined with the 2016 income on page 2 of **Schedule E**. The total \$50,000 loss carryforward (\$20,000 from basis limitations allowed under Step 1 and \$30,000 from at-risk limitations allowed under Step 2) was entered as a separate item with "PYA" (prior year amount) written in column (a). Ben checked the box for **yes** on line 27 to indicate that he was taking a loss suspended from a prior tax year.

The remainder of the suspended \$20,000 passive loss from 2015 is shown on the Form 8582. However, with no passive income to offset, Ben carries forward the suspended passive loss to 2017.

## For Example 11

<b>Form 8582</b> Department of the Treasury Internal Revenue Service (99)	<b>Passive Activity Loss Limitations</b> ▶ See separate instructions. ▶ Attach to Form 1040 or Form 1041. ▶ Information about Form 8582 and its instructions is available at <a href="http://www.irs.gov/form8582">www.irs.gov/form8582</a> .	OMB No. 1545-1008 <b>2016</b> Attachment Sequence No. <b>88</b>
Name(s) shown on return <b>Ben</b>		Identifying number <b>123-12-3123</b>
<b>Part I 2016 Passive Activity Loss</b> <b>Caution:</b> Complete Worksheets 1, 2, and 3 before completing Part I.		
<b>Rental Real Estate Activities With Active Participation</b> (For the definition of active participation, see Special Allowance for Rental Real Estate Activities in the instructions.)		
<b>1a</b> Activities with net income (enter the amount from Worksheet 1, column (a))	<b>1a</b>	
<b>b</b> Activities with net loss (enter the amount from Worksheet 1, column (b))	<b>1b</b> (                      )	
<b>c</b> Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	<b>1c</b> (                      )	
<b>d</b> Combine lines 1a, 1b, and 1c	<b>1d</b>	
<b>Commercial Revitalization Deductions From Rental Real Estate Activities</b>		
<b>2a</b> Commercial revitalization deductions from Worksheet 2, column (a)	<b>2a</b> (                      )	
<b>b</b> Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	<b>2b</b> (                      )	
<b>c</b> Add lines 2a and 2b	<b>2c</b> (                      )	
<b>All Other Passive Activities</b>		
<b>3a</b> Activities with net income (enter the amount from Worksheet 3, column (a))	<b>3a</b>	
<b>b</b> Activities with net loss (enter the amount from Worksheet 3, column (b))	<b>3b</b> (                      )	
<b>c</b> Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	<b>3c</b> (                      20,000                      )	
<b>d</b> Combine lines 3a, 3b, and 3c	<b>3d</b>	<b>(20,000)</b>
<b>4</b> Combine lines 1d, 2c, and 3d. If this line is zero or more, stop here and include this form with your return; all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. Report the losses on the forms and schedules normally used	<b>4</b>	<b>(20,000)</b>
If line 4 is a loss and: <ul style="list-style-type: none"> <li>• Line 1d is a loss, go to Part II.</li> <li>• Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.</li> <li>• Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.</li> </ul>		
<b>Caution:</b> If your filing status is married filing separately and you lived with your spouse at any time during the year, <b>do not</b> complete Part II or Part III. Instead, go to line 15.		
<b>Part II Special Allowance for Rental Real Estate Activities With Active Participation</b> <b>Note:</b> Enter all numbers in Part II as positive amounts. See instructions for an example.		
<b>5</b> Enter the <b>smaller</b> of the loss on line 1d or the loss on line 4	<b>5</b>	
<b>6</b> Enter \$150,000. If married filing separately, see instructions	<b>6</b>	
<b>7</b> Enter modified adjusted gross income, but not less than zero (see instructions)	<b>7</b>	
<b>Note:</b> If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.		
<b>8</b> Subtract line 7 from line 6	<b>8</b>	
<b>9</b> Multiply line 8 by 50% (0.5). <b>Do not</b> enter more than \$25,000. If married filing separately, see instructions	<b>9</b>	
<b>10</b> Enter the <b>smaller</b> of line 5 or line 9	<b>10</b>	<b>0</b>
If line 2c is a loss, go to Part III. Otherwise, go to line 15.		
<b>Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities</b> <b>Note:</b> Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.		
<b>11</b> Enter \$25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	<b>11</b>	
<b>12</b> Enter the loss from line 4	<b>12</b>	
<b>13</b> Reduce line 12 by the amount on line 10	<b>13</b>	
<b>14</b> Enter the <b>smallest</b> of line 2c (treated as a positive amount), line 11, or line 13	<b>14</b>	
<b>Part IV Total Losses Allowed</b>		
<b>15</b> Add the income, if any, on lines 1a and 3a and enter the total	<b>15</b>	<b>0</b>
<b>16</b> Total losses allowed from all passive activities for 2016. Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return	<b>16</b>	<b>0</b>

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 63704F

Form **8582** (2016)

# 2017 Workbook

## For Example 11

Form 8582 (2016)

Page **2**

**Caution:** The worksheets must be filed with your tax return. Keep a copy for your records.

**Worksheet 1—For Form 8582, Lines 1a, 1b, and 1c** (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 1a)	(b) Net loss (line 1b)	(c) Unallowed loss (line 1c)	(d) Gain	(e) Loss
<b>Total. Enter on Form 8582, lines 1a, 1b, and 1c</b>					

**Worksheet 2—For Form 8582, Lines 2a and 2b** (See instructions.)

Name of activity	(a) Current year deductions (line 2a)	(b) Prior year unallowed deductions (line 2b)	(c) Overall loss
<b>Total. Enter on Form 8582, lines 2a and 2b</b>			

**Worksheet 3—For Form 8582, Lines 3a, 3b, and 3c** (See instructions.)

Name of activity	Current year		Prior years	Overall gain or loss	
	(a) Net income (line 3a)	(b) Net loss (line 3b)	(c) Unallowed loss (line 3c)	(d) Gain	(e) Loss
J&B, LLC	0	0	20,000		20,000
<b>Total. Enter on Form 8582, lines 3a, 3b, and 3c</b>	0	20,000			

**Worksheet 4—Use this worksheet if an amount is shown on Form 8582, line 10 or 14** (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Special allowance	(d) Subtract column (c) from column (a)
<b>Total</b>			1.00		

**Worksheet 5—Allocation of Unallowed Losses** (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Ratio	(c) Unallowed loss
J&B, LLC	E Ln 28A	20,000	1.00	20,000
<b>Total</b>		20,000	1.00	20,000

Form **8582** (2016)

# 2017 Workbook

## For Example 11

Form 8582 (2016)

Page **3**

### Worksheet 6— Allowed Losses (See instructions.)

Name of activity	Form or schedule and line number to be reported on (see instructions)	(a) Loss	(b) Unallowed loss	(c) Allowed loss
J&B, LLC	E Ln 28A	20,000	20,000	0
<b>Total</b>		<b>20,000</b>	<b>20,000</b>	<b>0</b>

### Worksheet 7— Activities With Losses Reported on Two or More Forms or Schedules (See instructions.)

Schedule E (Form 1040) 2016

Attachment Sequence No. **13**

Page **2**

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

Your social security number

**Ben**

**123-12-3123**

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II** **Income or Loss From Partnerships and S Corporations** **Note:** If you report a loss from an at-risk activity for which any amount is **not** at risk, you **must** check the box in column (e) on line 28 and attach **Form 6198**. See instructions.

**27** Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section. ☒ **Yes** ☐ **No**

<b>28</b>	(a) Name	(b) Enter <b>P</b> for partnership; <b>S</b> for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk
<b>A</b>	<b>J&amp;B, LLC</b>	<b>P</b>	<input type="checkbox"/>	<b>12-0123123</b>	<input checked="" type="checkbox"/>
<b>B</b>	<b>PYA</b>	<b>P</b>	<input type="checkbox"/>	<b>12-0123123</b>	<input checked="" type="checkbox"/>
<b>C</b>			<input type="checkbox"/>		<input type="checkbox"/>
<b>D</b>			<input type="checkbox"/>		<input type="checkbox"/>

Passive Income and Loss				Nonpassive Income and Loss			
	(f) Passive loss allowed (attach <b>Form 8582</b> if required)	(g) Passive income from <b>Schedule K-1</b>	(h) Nonpassive loss from <b>Schedule K-1</b>	(i) Section 179 expense deduction from <b>Form 4562</b>	(j) Nonpassive income from <b>Schedule K-1</b>		
<b>A</b>		<b>50,000</b>					
<b>B</b>	<b>50,000</b>						
<b>C</b>							
<b>D</b>							
<b>29a Totals</b>		<b>50,000</b>					
<b>b Totals</b>	<b>50,000</b>						
<b>30</b>	Add columns (g) and (j) of line 29a . . . . .					<b>30</b>	<b>50,000</b>
<b>31</b>	Add columns (f), (h), and (i) of line 29b . . . . .					<b>31</b>	<b>( 50,000 )</b>
<b>32</b>	<b>Total partnership and S corporation income or (loss).</b> Combine lines 30 and 31. Enter the result here and include in the total on line 41 below . . . . .					<b>32</b>	<b>0</b>

### Part III Income or Loss From Estates and Trusts

## DISTRIBUTIONS

Partnership distributions are classified as either **current or liquidating**. A distribution that does not liquidate a partner's entire interest is a current distribution.<sup>56</sup> If a partner's entire interest is terminated after the distribution, the interest has been liquidated. Liquidation may be accomplished through a single distribution or a series of distributions to the partner by the partnership.

**Note.** For more information on liquidating distributions, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues.

### CURRENT DISTRIBUTION OF ASSETS

Money and marketable securities can be withdrawn with no recognition of gain or loss unless the money and/or the FMV of the securities distributed exceeds the partner's adjusted basis in the partnership.<sup>57</sup> If any other assets (aside from cash or securities) are distributed, the partner's adjusted basis in the partnership is reduced by the adjusted basis of the asset to the partnership.<sup>58</sup> When there is a distribution of money and property in the same transaction, the money reduces the member's outside basis first.<sup>59</sup> Any remaining outside basis is reduced by property basis.<sup>60</sup>

The basis of the assets distributed to the partner equals the adjusted basis of the assets in the partnership immediately prior to the distribution.<sup>61</sup> However, the basis may not exceed the outside basis in the partner interest after any reduction for cash and marketable securities received.<sup>62</sup>

If depreciable property is distributed to a partner, the partner continues the cost-recovery method and life as established on the partnership books as long as the adjusted basis in the partner's hands is the same as what was included on the partnership books.<sup>63</sup> When IRC §§1245 or 1250 **recapture** is associated with the depreciable asset, the sale or exchange rules under IRC §751 for unrealized receivables and inventory items may apply (discussed later).

A partner who contributed property to the partnership may be required to recognize a gain or loss if the property is distributed. This applies if the contributed property is distributed to a partner other than the contributing partner **within seven years** after being contributed.<sup>64</sup> This rule is designed to prevent shifting of income from one partner to another.

**Note.** The rule for contributed property also applies to a **successor** to the partner's interest.<sup>65</sup>

**Example 12.** Amie contributed an asset with a basis of \$1,000 and an FMV of \$1,500 in exchange for an interest in a partnership. Immediately thereafter, the partnership distributed the asset to Barry, another partner. Amie reported a \$500 gain on her personal return, which increased her basis. Barry's basis was reduced by the \$1,500 FMV of the asset.

**Note.** For more information about distributions, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues.

<sup>56</sup> Treas. Reg. §1.761-1(d).

<sup>57</sup> IRC §§731(a)(1) and 731(c). See also Treas. Reg. §1.731-1(a)(1).

<sup>58</sup> IRC §732.

<sup>59</sup> IRC §732(a)(2).

<sup>60</sup> Ibid.

<sup>61</sup> Ibid.

<sup>62</sup> IRC §732(a)(1).

<sup>63</sup> IRC §168(i)(7).

<sup>64</sup> IRC §704(c)(1)(B).

<sup>65</sup> Treas. Reg. §1.704-4(d)(2).



## PROPORTIONATE DISTRIBUTION OF ALL ASSETS<sup>66</sup>

If a partnership is terminated through a distribution of partnership assets, a partner does not recognize a gain as long as the distributed money and/or marketable securities does **not** exceed the partner's adjusted outside basis in the partnership.<sup>67</sup>

A partner does not recognize loss on a partnership distribution unless all the following requirements are met.<sup>68</sup>

- The adjusted basis of the partner's interest in the partnership exceeds the distribution.
- The partner's entire interest in the partnership is liquidated.
- The distribution is in money, unrealized receivables, or inventory items.

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money (and/or marketable securities) distributed to the partner in the same transaction. The remaining basis must be divided among the properties received by the partner in the following order.

**Step 1.** Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

**Step 2.** Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution. If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess. If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess.

Allocate any **basis increases** required in step 2 to properties with unrealized appreciation to the extent of the unrealized appreciation. If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation. Allocate any remaining basis increase among all the properties in proportion to their respective FMVs.

Allocate any **basis decreases** required in steps 1 or 2 using the following rules.

- Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation. If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation.
- Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts as decreased by step 1.

## DISPROPORTIONATE DISTRIBUTIONS

A partner may receive a distribution of property in exchange for all or a part of their partnership interest. However, any disproportionate distribution of unrealized receivables or substantially appreciated inventory is considered a sale or exchange of the property between the partner and the partnership.<sup>69</sup>

<sup>66</sup> IRS Pub. 541, *Partnerships*.

<sup>67</sup> IRC §731(a)(1).

<sup>68</sup> IRC §731(a)(2).

<sup>69</sup> IRC §751.



## GUARANTEED PAYMENTS TO PARTNERS

Guaranteed payments to partners are reported on Schedule K-1 in box 4.<sup>70</sup> Guaranteed payments may be compensation for services or compensation for the use of capital.<sup>71</sup> Guaranteed payments are determined without regard to the partnership's profit or loss.

A guaranteed payment is **taxed as ordinary income** to the recipient partner<sup>72</sup> and may be offset by the partner's share of the partnership's ordinary loss. The partner's taxable share of partnership ordinary income includes both their guaranteed payment and their share of ordinary income. This income is reported on the partner's return for the year that includes the end of the partnership's tax year, **regardless of the timing of the actual payments.**<sup>73</sup>

**Example 13.** Gary is a general partner of Retiring in Style. The partnership's tax year ends on June 30. Gary received guaranteed payments of \$10,000 per month from July 1, 2016, through June 30, 2017. The entire \$120,000 is reported as a guaranteed payment on his Schedule K-1 from the partnership for the fiscal year ending June 30, 2017. Even though he received half of the payments in 2016, he reports the entire \$120,000 on his 2017 return along with the other items shown on his Schedule K-1.

## FRINGE BENEFITS<sup>74</sup>

Guaranteed payments include most fringe benefits paid for the benefit of the partners. Some expenses associated with these taxable benefits may be deductible by the partners. Common taxable benefits include the following.

- Group-term life insurance premiums<sup>75</sup>
- Amounts received under accident and health plans<sup>76</sup>
- Premiums on accident and health insurance paid by the partnership<sup>77</sup>
- Voluntary and partnership contributions to health savings accounts<sup>78</sup>
- Meals and lodging provided by the partnership<sup>79</sup>
- Parking and transit passes provided by the partnership<sup>80</sup>

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<sup>70</sup> Partner's Instructions for Schedule K-1.

<sup>71</sup> Treas. Reg. §1.707-1(c).

<sup>72</sup> Treas. Reg. §1.707-1(c). See also *Falconer v. Comm'r*, 40 TC 1011 (Sep. 23, 1963).

<sup>73</sup> Treas. Reg. §1.707-1(c).

<sup>74</sup> IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

<sup>75</sup> IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*. See also IRC §79.

<sup>76</sup> Under IRC §105.

<sup>77</sup> Under IRC §106.

<sup>78</sup> IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*.

<sup>79</sup> Under IRC §119.

<sup>80</sup> Under IRC §132(f)(5)(E).

## Self-Employed Health Insurance<sup>81</sup>

Health insurance premiums paid by the partnership (directly or as a reimbursement) are included in guaranteed payments. The policy may be in the name of the partnership or in the name of the partner. Premiums for medical, dental, and qualified long-term care insurance paid by the partnership are included in the cost of self-employed health insurance. Eligible premiums may cover the taxpayer, their spouse, their dependents, and their children who were under age 27 at the end of the tax year. Eligible premiums also include Medicare premiums voluntarily paid for the taxpayer and all other qualified individuals,<sup>82</sup> as long as the partnership reimburses the partner for the expense.

Partnerships should report the qualified amount of health insurance payments in box 13 of Schedule K-1 using Code "M."<sup>83</sup> Partners may deduct the cost of self-employed health insurance from adjusted gross income on line 29 ("self-employed health insurance deduction") of Form 1040. The deduction is limited to net SE earnings from the partnership.<sup>84</sup> Any expense in excess of the net SE earnings may be deducted on Schedule A, *Itemized Deductions*, subject to the medical expense limitations.<sup>85</sup>

**Note.** The partner's Schedule K-1 shows net SE earnings for the year in box 14 using code A.<sup>86</sup> However, certain deductions, discussed later, that are passed through from the partnership reduce SE income below the amount reported on the Schedule K-1.

## Voluntary and Partnership Contributions to Health Savings Accounts<sup>87</sup>

Depending on the partnership agreement, contributions by a partnership to a partner's health savings account (HSA) may be included in distributions or in guaranteed payments. If the payments are made based on the partner's share of the partnership, the contributions are included in distributions. If they are made as compensation for services rendered, they are included in guaranteed payments. The partnership is not required to report the contributions on Schedule K-1, but, ideally, it will include the contribution amount in the Schedule K-1 supplemental information.

Because partners are not considered employees, both voluntary contributions and contributions to HSAs made by the partnership are treated as having been made directly by the partner. Therefore, the partner may deduct all of the HSA contributions made on their behalf, if all other requirements are satisfied. The deduction is calculated on Form 8889, *Health Savings Accounts (HSAs)*.

**Example 14.** Victoria is a limited partner of Griff, Ltd. She does not participate in the activities of the company. In 2016, Griff made a contribution to each partner's HSA based on the partner's ownership percentage in the company. Because the contributions were not compensation for services, the payments were classified as cash distributions. Victoria's Schedule K-1 included a supplemental report showing that her total distributions included \$2,000 contributed to her HSA.

Victoria's HSA is a self-only plan. She was under age 55 in 2016, so her annual contribution limit for 2016 is \$3,350.<sup>88</sup> Because partners are not employees, she was treated as having made the contributions directly. Accordingly, she reported the \$2,000 paid on line 2 of her Form 8889, which follows. She did not include the \$2,000 on line 9 because the partnership's contribution is not treated as having been made by an employer.

<sup>81</sup> IRS Pub. 535, *Business Expenses*.

<sup>82</sup> CCA 201228037 (Jul. 13, 2012).

<sup>83</sup> Partner's Instructions for Schedule K-1.

<sup>84</sup> IRC §162(l)(2)(A).

<sup>85</sup> Instructions for Schedule A.

<sup>86</sup> Partner's Instructions for Schedule K-1.

<sup>87</sup> IRS Notice 2005-8, 2005-4 IRB 368. See also IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

<sup>88</sup> IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

# 2017 Workbook

## For Example 14

Form <b>8889</b> Department of the Treasury Internal Revenue Service	<b>Health Savings Accounts (HSAs)</b> ► Information about Form 8889 and its separate instructions is available at <a href="http://www.irs.gov/form8889">www.irs.gov/form8889</a> . ► Attach to Form 1040 or Form 1040NR.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; margin: 5px 0;">2016</div> Attachment Sequence No. <b>52</b>
Name(s) shown on Form 1040 or Form 1040NR <b>Victoria</b>		Social security number of HSA beneficiary. If both spouses have HSAs, see instructions ► <b>333-44-1234</b>

**Before you begin:** Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

**Part I HSA Contributions and Deduction.** See the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse.

<p>1 Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2016 (see instructions). . . . . ►</p> <p>2 HSA contributions you made for 2016 (or those made on your behalf), including those made from January 1, 2017, through April 18, 2017, that were for 2016. <b>Do not</b> include employer contributions, contributions through a cafeteria plan, or rollovers (see instructions). . . . .</p> <p>3 If you were under age 55 at the end of 2016, and on the first day of <b>every</b> month during 2016, you were, or were considered, an eligible individual with the <b>same</b> coverage, enter \$3,350 (\$6,750 for family coverage). <b>All others</b>, see the instructions for the amount to enter . . . . .</p> <p>4 Enter the amount you and your employer contributed to your Archer MSAs for 2016 from Form 8853, lines 1 and 2. If you or your spouse had family coverage under an HDHP at any time during 2016, also include any amount contributed to your spouse's Archer MSAs . . . . .</p> <p>5 Subtract line 4 from line 3. If zero or less, enter -0- . . . . .</p> <p>6 Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2016, see the instructions for the amount to enter . . . . .</p> <p>7 If you were age 55 or older at the end of 2016, married, and you or your spouse had family coverage under an HDHP at any time during 2016, enter your additional contribution amount (see instructions) . . . . .</p> <p>8 Add lines 6 and 7 . . . . .</p> <p>9 Employer contributions made to your HSAs for 2016 . . . . .</p> <p>10 Qualified HSA funding distributions . . . . .</p> <p>11 Add lines 9 and 10 . . . . .</p> <p>12 Subtract line 11 from line 8. If zero or less, enter -0- . . . . .</p> <p>13 <b>HSA deduction.</b> Enter the <b>smaller</b> of line 2 or line 12 here and on Form 1040, line 25, or Form 1040NR, line 25 . . . . .</p>	<div style="text-align: right; margin-bottom: 10px;"> <input checked="" type="checkbox"/> Self-only    <input type="checkbox"/> Family         </div> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 10%; text-align: center; border: 1px solid black;">2</td> <td style="width: 50%; text-align: right; border: 1px solid black;">2,000</td> <td style="width: 40%;"></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">3</td> <td style="text-align: right; border: 1px solid black;">3,350</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">4</td> <td style="text-align: right; border: 1px solid black;">0</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">5</td> <td style="text-align: right; border: 1px solid black;">3,350</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">6</td> <td style="text-align: right; border: 1px solid black;">3,350</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">7</td> <td style="text-align: right; border: 1px solid black;">0</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">8</td> <td style="text-align: right; border: 1px solid black;">3,350</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">9</td> <td></td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">10</td> <td></td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">11</td> <td></td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">12</td> <td style="text-align: right; border: 1px solid black;">3,350</td> <td></td> </tr> <tr> <td style="text-align: center; border: 1px solid black;">13</td> <td style="text-align: right; border: 1px solid black;">2,000</td> <td></td> </tr> </table>	2	2,000		3	3,350		4	0		5	3,350		6	3,350		7	0		8	3,350		9			10			11			12	3,350		13	2,000	
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**Caution:** If line 2 is more than line 13, you may have to pay an additional tax (see instructions).

**HSA Distributions.** If you are filing jointly and both you and your spouse each have separate HSAs, complete

**Observation.** Victoria could have made an additional contribution for 2016 of \$1,350 (\$3,350 limit – \$2,000 already contributed) to her HSA directly from her own funds at any time before April 18, 2017 (the 2016 return deadline). If she had done that, the amount on line 2 would include both the contribution made by the partnership and the contribution she made directly.<sup>89</sup>

**Caution.** In order to contribute to an HSA for a given calendar year, the participant must have an HSA-qualified high deductible health plan in place by December 1 of the calendar year.<sup>90</sup>

<sup>89</sup> Instructions for Form 8889.

<sup>90</sup> IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

## SELF-EMPLOYMENT TAXES

**Note.** Partners who perform services in the conduct of the trade or business of the partnership are not employees of the partnership.<sup>91</sup>

It is the partnership's responsibility to identify the total amount of income from the partnership subject to SE tax for each partner. The SE amount is reported in box 14 with code "A" on each partner's Schedule K-1.<sup>92</sup> However, the amount reported is before certain deductions that may be claimed on the partner's personal return. The additional deductions that reduce SE tax may include interest expense, unreimbursed partnership expenses, the §179 deduction, §59(e)(2) expenditures, and depletion.<sup>93</sup>

### SE TAX ON DISTRIBUTIONS

**General partners** are treated as receiving income from self-employment and are subject to SE tax on their distributive shares of income from a partnership.<sup>94</sup> There are exceptions for certain types of income distributions, including rent, gain or loss from disposition of property, and investment income.<sup>95</sup>

Distributive shares of **limited partners'** income or loss are excluded from SE earnings.<sup>96</sup> Accordingly, a limited partner's distributive share of income from a partnership is not subject to SE taxes.

However, for SE tax purposes, the mere designation of partner as "limited" is not determinative. The Chief Counsel recently made a distinction between partners who "merely" invest in an entity and partners who actively participate in the entity's business.<sup>97</sup> The Chief Counsel concluded that **actively participating** partners must include the entity's income in SE income even though they are not designated as general partners.

**Note.** For purposes of discussing SE taxes in this chapter, the term **general partner** is also used to describe any LLC/LLP partner whose duties and activity levels are comparable to a general partner's.

<sup>91</sup> *Entities*. Feb. 6, 2017. IRS. [www.irs.gov/help-resources/tools-faqs/faqs-for-individuals/frequently-asked-tax-questions-answers/small-business-self-employed-other-business/entities/entities-1] Accessed on Aug. 9, 2017.

<sup>92</sup> Partner's Instructions for Schedule K-1.

<sup>93</sup> *Ibid.*

<sup>94</sup> IRC §1402(a).

<sup>95</sup> IRC §§1402(a)(1)–(3).

<sup>96</sup> IRC §1402(a)(13).

<sup>97</sup> CCA 201640014 (Jun. 15, 2016).

## SE TAX ON GUARANTEED PAYMENTS

Guaranteed payments **for services** that are made in the course of a partnership's **trade or business** are considered SE income and are subject to SE tax.<sup>98</sup> This is true regardless of whether the partner is a general or limited partner.<sup>99</sup>

Guaranteed payments for the use of capital are specifically included in SE income under Treas. Reg. §1.1402(a)-1(b). However, the regulations do not reflect the addition of IRC §1402(a)(13)<sup>100</sup> that excludes the **distributive share of income** allocated to limited partners from SE income. That Code provision, however, specifically **includes guaranteed payments for services** “actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services” in SE income. Accordingly, it could be argued that a **limited** partner who provides **no services** to the partnership is not subject to SE tax on guaranteed payments for the use of capital.

**Note.** Fringe benefits such as health insurance and HSA contributions **that are included in guaranteed payments** are also included in SE income. There are no provisions that would allow them to be excluded for SE tax purposes.

## NETTING ORDINARY INCOME (LOSS) AND GUARANTEED PAYMENTS<sup>101</sup>

A taxpayer's net SE income may include the following.

1. Net income and losses from any sole proprietorships owned by the taxpayer
2. Ordinary business income and losses passed through to the taxpayer as a general partner and adjusted for deductions taken at the partner level
3. Guaranteed payments for services provided to a partnership's trade or business by general or limited partners
4. Guaranteed payments for use of capital provided to a partnership's trade or business by a general partner (and possibly a limited partner)

**Example 15.** Mark operates a sole proprietorship providing bike tours of Boston. He also owns a 50% interest in Loved 'Em and Left 'Em, LLP (LE & LE, LLP). The LLP specializes in divorce law. Mark and his partner each work full time for the firm. In 2016, Mark's net SE earnings was composed of the following.

Boston Biking	\$ 10,000
Net business loss from LE & LE, LLP	(3,000)
Guaranteed payments from LE & LE, LLP	150,000
Net SE earnings	<u>\$157,000</u>

<sup>98</sup>. Treas. Reg. §1.1402(a)-1(b).

<sup>99</sup>. IRC §1402(a)(13). See also *Howell v. Comm'r*, TC Memo 2012-303 (Nov. 1, 2012).

<sup>100</sup>. PL 95-216 added IRC §1402(a)(12); subsequently PL 98-21 changed the paragraph number to (13).

<sup>101</sup>. Rev. Rul. 56-675, 1956-2 CB 459.

## IRC §179 DEDUCTION

The IRC §179 deduction for qualified property is subject to limitations at both the partnership and individual partner levels.<sup>102</sup> After applying the partnership level limitations, the tentative amount deductible by each partner is reported on Schedule K-1.<sup>103</sup>

Each partner must determine if they can claim the amount of the §179 deduction passed through to them. This determination is based on the following factors.

1. The partner's basis in the partnership
2. The partner's participation in the activities of the partnership
3. The annual §179 deduction limit
4. The partner's total business income

Because of these limitations, dispositions of §179 property by the partnership are reported separately to each partner. This permits the partner to adjust the gain or loss from disposition based on how much, if any, of the §179 deduction was actually used by the partner.

### BASIS

Each partner must reduce the basis of their partnership interest by the full amount of the partnership's §179 deduction that is allocated to them, regardless of whether the partner may deduct the entire amount.<sup>104</sup> Basis may not be reduced below zero.<sup>105</sup>

If a partner does not have sufficient basis to claim the entire §179 deduction that passed through to them, the excess deduction is suspended until sufficient basis exists.<sup>106</sup> (Calculation of basis is discussed earlier in the chapter.)

### ACTIVE PARTICIPATION REQUIREMENT

The §179 deduction is limited to the taxpayer's taxable income from the **active conduct** of any trade or business during the tax year.<sup>107</sup> The term **trade or business** has the same general meaning as used throughout the Code.<sup>108</sup>

Generally, **active conduct** means meaningful participation in the management or operation of the trade or business.<sup>109</sup> For purposes of the business income limit, if a partner actively participates in one or more of a partnership's trades or businesses, the business income from **all of the partnership's** trades or businesses is included in business income from the partnership.<sup>110</sup>

**Note.** The Code specifically uses the term **active conduct** with respect to the taxpayer's participation requirement in activities taken into account for purposes of the §179 deduction. This is a lesser standard than **material participation**. **Material participation** is defined earlier in the "Passive Loss" section of the chapter. For more information about material participation, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [taxschool.illinois.edu/taxbookarchive].

<sup>102</sup> IRC §179(d)(8).

<sup>103</sup> Instructions for Form 1065.

<sup>104</sup> Rev. Rul. 89-7, 1989-1 CB 178.

<sup>105</sup> IRS Pub. 541, *Partnerships*.

<sup>106</sup> Treas. Reg. §1.179-3(h).

<sup>107</sup> IRC §179(b)(3)(A).

<sup>108</sup> Treas. Reg. §1.179-2(c)(6)(i).

<sup>109</sup> Treas. Reg. §1.179-2(c)(6)(ii).

<sup>110</sup> IRS Pub. 946, *How To Depreciate Property*.



If a partner neither actively nor materially participates in the partnership's activities, they cannot claim the §179 deduction that passed through from the partnership. Treas. Reg. §1.179-2(c)(6)(ii) states the following.

*In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business.*

If a partner is not allowed to use the §179 deduction because they fail the active participation test, the disallowed §179 deduction is suspended until the partnership disposes of the asset<sup>111</sup> or the partner disposes of their interest in the partnership.<sup>112</sup>

## THE ANNUAL §179 DEDUCTION LIMIT

The annual §179 deduction is limited to \$510,000 for 2017.<sup>113</sup> When a partner receives a distributive share of §179 expenses from multiple sources, the partner's total §179 expenses may exceed the maximum dollar amount allowable for the tax year. The excess §179 expenses may not be carried over.<sup>114</sup>

Despite this limitation, the partner's adjusted basis in their partnership interest must be reduced by the partner's full distributive share of the §179 deduction passed through to them.<sup>115</sup>

**Example 16.** For the 2016 tax year, Erica received a Schedule K-1 from Wright Sisters LLC, which allocated \$450,000 of taxable income and \$400,000 of §179 expense to her. Erica also received a Schedule K-1 from TakeTwo LLC, which allocated \$225,000 of taxable income and \$200,000 of §179 expenses to her. The total §179 deductions allocated to her were \$600,000 (\$400,000 + \$200,000).

The maximum allowable §179 deduction for 2016 was \$500,000.<sup>116</sup> Because Erica's total §179 deduction is \$100,000 over the maximum amount allowable for 2016 (\$600,000 – \$500,000), she cannot carry over the excess to a subsequent year. However, Erica's basis in her LLC interests must be reduced by the entire amount of the §179 deductions that were allocated to her.

When the partnership disposes of the asset or the partner disposes of their partnership interest, the §179 deductions disallowed because of this limitation are taken into account in determining the basis of the disposed property. This adjustment is explained later in this section.

## BUSINESS INCOME LIMITATION<sup>117</sup>

Income for purposes of the business income limit includes the income and losses from **all** trades or businesses in which the taxpayer actively participates.<sup>118</sup> A taxpayer's business income includes the following.

1. Net income from trades or businesses computed without regard to the §179 deduction
2. IRC §1231 gains (or losses)
3. Interest from working capital of the taxpayer's trades or businesses
4. Wages, salaries, tips, and other compensation earned as an employee
5. Guaranteed payments received from partnerships

<sup>111</sup>. Treas. Reg. §1.179-3(f); Instructions for Form 4797.

<sup>112</sup>. Treas. Reg. §§1.179-3(g) and (h).

<sup>113</sup>. Rev. Proc. 2016-55, 2016-45 IRB 707.

<sup>114</sup>. Treas. Reg. §1.179-2(b).

<sup>115</sup>. Treas. Reg. §1.179-3(h)(1).

<sup>116</sup>. IRC §179(b)(1).

<sup>117</sup>. Instructions for Form 4562. See also IRS Pub. 946, *How to Depreciate Property*.

<sup>118</sup>. IRC §179(b)(3)(A).



The deduction for half of the SE tax is not included in the computation of business income. Net operating loss carrybacks and carryforwards are also excluded from this computation, as are unreimbursed employee business expenses.

**Example 17.** Zeke is a limited partner in Magister's LLC, which did not elect to be taxed as a C or S corporation. Zeke owns 80% of the partnership and actively participates in the activities of the LLC. His 2016 Schedule K-1 shows the following.

Box 1: Ordinary business income (loss)	(\$80,000)
Box 4: Guaranteed payments	130,000
Box 12: Section 179 deduction	40,000

Zeke also incurred \$2,000 of unreimbursed partnership expenses for use of his personal vehicle for business travel related to the LLC. By agreement between the partners, the partnership does not reimburse partners for mileage expense.

Zeke did not have any other trade or business activities in 2016. His business income for purposes of the income limitation was \$48,000 as calculated below.

Ordinary business income (loss)	(\$ 80,000)
Unreimbursed partnership expenses	(2,000)
Guaranteed payments	130,000
Total business income	\$ 48,000

Zeke was able to deduct all of the \$40,000 IRC §179 deduction allocated to him by the LLC.

If the partner cannot deduct the entire §179 pass-through expense because of limitations on their personal return, the excess deduction is carried forward.<sup>119</sup> Nevertheless, the partner's basis in the partnership **is currently** reduced by the entire amount.<sup>120</sup>

**Example 18.** Troy is a partner of a partnership that passes through \$50,000 of the 2017 net profit to Troy. In addition, it passes through a §179 deduction of \$5,000. Troy also operates a Schedule C business. It incurs a loss of \$60,000 for the year. Troy has no other earned income. Therefore, his business activities incurred a net loss of \$10,000 (\$50,000 – \$60,000) for the year. Consequently, he is unable to use any of the pass-through §179 deduction.

Troy's basis in his partnership interest was \$8,000 at the beginning of the year. At the end of the year, it is \$53,000 (\$8,000 beginning basis + \$50,000 net profit – \$5,000 §179 expense). **Troy carries the unused §179 deduction forward because of the business income limitation.**

## CLAIMING THE IRC §179 DEDUCTION<sup>121</sup>

If the partner materially participates in the partnership's activities, the §179 amount reported on Form 4562 is carried to line 28 of Schedule E. If the partner **does not materially participate** in the partnership's activities but **does actively participate**, the amount from Form 4562, line 12, is carried to Form 8582.

<sup>119</sup>. Treas. Reg. §1.179-3(a).

<sup>120</sup>. Treas. Reg. §1.179-3(h)(1).

<sup>121</sup>. Partner's Instructions for Schedule K-1.

## DISPOSITION OF IRC §179 PROPERTY

A partnership reports a sale or other disposition of property for which the §179 deduction was previously passed through to the partners in box 20 (“other information”) of Schedule K-1 using Code L.<sup>122</sup> A partnership must also provide its partners with detailed information about the disposition of the asset so the partners can properly report the disposition on their individual Forms 4797, *Sales of Business Property*. Each partner calculates their portion of depreciation allowed or allowable for the asset using the following formula.<sup>123</sup>

$$\begin{array}{r} \text{Depreciation allowed or allowable (as reported by the partnership to the partner)} \\ + \text{ The §179 deduction (as reported by the partnership to the partner)} \\ - \text{ Any of the partner's unused carryover of the §179 deduction for this property} \\ \hline \text{Depreciation allowed or allowable to report on Form 4797} \end{array}$$

**Note.** These rules are consistent with the rules applicable to S corporation shareholders. See the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: S Corporation Shareholder Issues. **Examples 23 and 24** show how a passive partner should treat the disposition of §179 property.

## LOANS BY A PARTNER

### LOANS TO BUY AN OWNERSHIP INTEREST<sup>124</sup>

IRS guidance on allocating and deducting interest expense on debt-financed acquisitions of interests in S corporations and partnerships is based on Temp. Treas. Reg. §1.163-8T, which applies to individual taxpayers. The tracing and ordering rules discussed in this section of the chapter apply to **all** interest expense deductions for **individuals**, not just the deductions related to acquisitions of S corporation and partnership interests.

#### Allocation of Loan Proceeds

A taxpayer who borrows money to buy into a partnership must allocate the loan proceeds into the appropriate classes in order to determine which set of rules apply. The first consideration when making this allocation is whether a taxpayer purchased the partnership interest from the partnership or another partner.

If a taxpayer purchases their partnership interest **directly from the partnership** (e.g., makes a capital contribution to the partnership in exchange for their partnership interest), the interest expense is allocated using **any reasonable method**, including the following.

- Methods based on the **assets owned by the partnership**
- Methods based on the use of the contributed capital by the partnership under the tracing rules

If a taxpayer purchases their partnership interest **from another partner**, the interest expense is allocated according to any reasonable method **that is based on the assets** of the partnership. Such methods may include pro-rata allocation based on an asset's FMV, book value, or adjusted basis, reduced by any debt of the pass-through entity or the owner allocated to such assets.<sup>125</sup> Use of a method based on anything other than the assets is not allowed.

<sup>122</sup>. Ibid.

<sup>123</sup>. Ibid.

<sup>124</sup>. IRS Notice 89-35, 1989-1 CB 675.

<sup>125</sup>. See Ltr. Rul. 9116008 (Jan. 10, 1991) and Ltr. Rul. 9441025 (Jul. 11, 1994) for IRS examples of allocations based on assets when the partnership interest was acquired from another partner.

**Example 19.** Marty Jones purchases a 25% interest in the Healthy Home LLC, a multi-member LLC taxed as a partnership, for \$150,000. Marty borrows the necessary funds on an unsecured line of credit at his local bank at an interest rate of 10%. The FMV and adjusted tax basis of Healthy Home LLC's assets follow.

	FMV	Adjusted Tax Basis
Business equipment	\$600,000	\$300,000
Accumulated depreciation	0	(200,000)
Loan payable on equipment	(200,000)	0
Net value/basis of equipment	\$400,000	\$100,000
Cash in bank	200,000	200,000
Total assets	\$600,000	\$300,000

If Marty allocates the interest expense paid on his \$150,000 note using the FMV of the partnership's assets, then  $\frac{2}{3}$  ( $\$400,000 \div \$600,000$ ) of the interest expense will be allocated to business equipment and  $\frac{1}{3}$  ( $\$200,000 \div \$600,000$ ) of the interest expense will be allocated to investment assets. Therefore, Marty's interest expense is allocated  $\frac{2}{3}$  to business interest expense and  $\frac{1}{3}$  to investment interest expense.

If Marty allocates the interest expense using the adjusted tax basis of the partnership's assets, then only  $\frac{1}{3}$  of the interest will be business interest ( $\$100,000 \div \$300,000$ ) and the remaining  $\frac{2}{3}$  ( $\$200,000 \div \$300,000$ ) will be investment interest.

**Observation.** IRS Notice 89-35<sup>126</sup> requires debt to be allocated among **all** assets of a pass-through entity (unless the tracing approach is properly used). The phrase "all assets" includes bank accounts (classified as investments), physical assets, and intangible assets. Self-created intangible assets, such as self-created goodwill and customer base, and equipment depreciated under accelerated methods generally have little or no basis or book value. Therefore, taxpayers may want to use FMV for debt allocations in an entity conducting an active trade or business. This usually results in owners receiving a larger business interest deduction and minimizing that portion of debt allocable to investment or other nonbusiness assets.

The facts and circumstances determine whether an allocation method is reasonable. One significant factor is whether a taxpayer consistently applies the method from year to year. Accordingly, if the debt proceeds are allocated based on the partnership assets, the proceeds must be reallocated as the values or bases of an entity's assets change or the use of such assets change. If the debt proceeds are allocated based on tracing rules, the debt proceeds must be reallocated under the following circumstances.<sup>127</sup>

1. The asset to which the debt was allocated is sold and the proceeds are used for another expenditure.
2. The use of the asset changes.
3. The proceeds that were held in the borrower's account are used for another expenditure.

**Tracing Rules.**<sup>128</sup> In general, under the tracing rules, debt is allocated to expenditures according to how the debt proceeds are used. The allocation is not affected by the property used to secure the repayment of the debt unless the debt is qualified debt secured by the taxpayer's residence.

<sup>126</sup>. IRS Notice 89-35, 1989-1 CB 675.

<sup>127</sup>. See Temp. Treas. Reg. §1.163-8T(c)(4) and (j).

<sup>128</sup>. Temp. Treas. Reg. §1.163-8T(c).

Loan proceeds that are held in a taxpayer's account are treated as property held for investment until the proceeds are spent. Generally, debt proceeds are treated as being used **before** either of the following.

1. Any unborrowed amounts held in the account at the time the debt proceeds are deposited
2. Any amounts that are deposited into the account after the debt proceeds are deposited

Despite these rules, the taxpayer may treat **any** expenditure made from any account of the taxpayer **within 30 days** before or after debt proceeds are deposited as made from the debt proceeds.<sup>129</sup> In addition, interest earned on an account consisting solely of the deposited debt may be treated as being spent before the loan proceeds.<sup>130</sup>

**Qualified Residence Interest.** If debt is secured by a qualified residence and otherwise satisfies the requirements for treatment as home equity debt, it is home equity debt regardless of the use of the debt.<sup>131</sup> A **qualified residence** is the taxpayer's principal residence plus any second residence elected by the taxpayer.<sup>132</sup> The interest therefore must be deducted as mortgage interest on Schedule A. The tracing rules are disregarded for purposes of determining home equity debt.<sup>133</sup>

It may not always be desirable to deduct interest on home equity debt on Schedule A. Because lenders often require a lien on a residence to secure a business loan, the borrower may be better off treating that debt as business debt rather than as home equity debt.

**Example 20.** Claire has a single qualified residence in which she has \$40,000 of equity. She takes out a \$30,000 business loan secured by a recorded lien on the residence. The loan **must be** treated as home-equity debt and the interest is deductible only on Schedule A.

To avoid problems like this, the regulations allow a taxpayer to elect to treat any debt secured by a qualified residence as **not secured** by the residence.<sup>134</sup> This permits a taxpayer to avoid treating business debt as home-equity debt simply because it was secured by a qualified residence.

**Example 21.** By electing to treat the \$30,000 debt in **Example 20** as not secured by the residence, the debt no longer qualifies as home-equity debt. The tracing rules therefore apply, resulting in Claire treating the debt as business debt.

The election can be made any year, not just in the year the debt is incurred. Once the election is made, it is irrevocable without the IRS's consent.<sup>135</sup> There is no form prescribed in the regulations or other published IRS guidance to make the election. The Tax Court has stated that when there is no guidance on the manner of making an election, the taxpayer must "clearly notify the Commissioner of the taxpayer's intent to do so."<sup>136</sup> The following statement attached to the taxpayer's return for a tax year should be sufficient for making the election.

*I hereby elect in accordance with Temporary Regulation § 1.163-10T(o)(5)(i) to treat debt in the amount of \$[amount] under promissory note dated [date] to [Name of lender] as not being secured by my residence.*

**Note.** The regulations state that "any debt" is eligible for this election.<sup>137</sup> They do not affirmatively state that a portion of a debt can be elected, but it also does not say that the election applies only to the entire debt. The use of the term "any debt" also seems to indicate that the election is made on the basis of individual indebtedness rather than constituting a method of accounting that must thereafter be used for all such indebtedness.

<sup>129</sup> IRS Notice 89-35, 1989-1 CB 675. (See Section VI)

<sup>130</sup> Temp. Treas. Reg. § 1.163-8T(c)(4)(iii)(c).

<sup>131</sup> Temp. Treas. Reg. § 1.163-8T(m)(3).

<sup>132</sup> Temp. Treas. Reg. § 1.163-10T(p).

<sup>133</sup> Temp. Treas. Reg. § 1.163-8T(m)(3).

<sup>134</sup> Temp. Treas. Reg. § 1.163-10T(o)(5).

<sup>135</sup> Ibid.

<sup>136</sup> See, e.g., *Kosonen v. Comm'r*, TC Memo 2000-107 (Mar. 28, 2000).

<sup>137</sup> Temp. Treas. Reg. § 1.163-10T(o)(5).

## Debt Repayment Ordering Rule<sup>138</sup>

Once the debt has been allocated to multiple expenditures, repayments of the debt must be applied in the following order.

1. Personal expenditures
2. Investment expenditures and passive activity expenditures other than those specified in item #3.
3. Passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of §469(i))
4. Former passive activity expenditures
5. Amounts allocated to trade or business expenditures

4

## Reporting Rules<sup>139</sup>

Individuals report interest expense paid or incurred in connection with debt-financed acquisitions on either Schedule E or Schedule A, *Itemized Deductions*, depending on the type of expenditure to which the interest expense is allocated. Based on the allocations made, interest expense is deducted on Form 1040 according to the following rules.

1. Interest expense allocated to a **trade or business** is reported in part II of Schedule E. This interest expense should be identified on a separate line as “business interest” followed by the name of the pass-through entity to which the interest expense relates. The amount of the interest expense should be entered in column (h). This interest expense is deductible without limitation if the partner is a nonpassive participant in the partnership.<sup>140</sup>
2. Interest expense allocated to a **passive activity** is reported on Form 8582 as a deduction from the activity in which such expenditure was made. The deductible amount<sup>141</sup> (if any) of the interest expense should be reported on part II of Schedule E. This interest expense should be identified on a separate line in column (a) as “passive interest” followed by the name of the pass-through entity to which the interest expense relates, and the amount of such interest expense should be entered in column (f).<sup>142</sup>
3. Interest expense allocated to an **investment** is entered on Form 4952, *Investment Interest Expense Deduction*. The deductible amount (if any) of such interest expense carries to line 14 (investment interest)<sup>143</sup> of Schedule A if the partner is a passive participant in the activity. However, if the partner is a nonpassive participant, the expense is reported on part II of Schedule E based on rule 1 or 2 above, as applicable. The Schedule E deduction is identified as “investment interest.”
4. Interest expense allocated to personal expenses other than qualified home mortgage interest is not deductible.<sup>144</sup>

**Note.** See IRS Notices 88-37<sup>145</sup> and 89-35<sup>146</sup> for information on allocating and deducting interest expense on debt-financed distributions.

<sup>138</sup>. Temp. Treas. Reg. §1.163-8T(d)(1).

<sup>139</sup>. IRS Notice 88-37, 1988-1 CB 522.

<sup>140</sup>. See Temp. Treas. Reg. §1.163-8T(b)(7).

<sup>141</sup>. As determined under Temp. Treas. Reg. §1.469-1T(f)(2)(ii).

<sup>142</sup>. Instructions for Schedule E.

<sup>143</sup>. Instructions for Form 4952.

<sup>144</sup>. IRC §163(h).

<sup>145</sup>. IRS Notice 88-37, 1988-1 CB 522.

<sup>146</sup>. IRS Notice 89-35, 1989-1 CB 675.

## LOANS INCURRED BY A PARTNER FOR PARTNERSHIP PURPOSES<sup>147</sup>

If a partner borrows money and loans it to the partnership, the interest the partner pays is treated as investment interest. The partner generally reports the interest paid on Form 4952. However, if the partner's share of the corresponding interest expense deduction passed through from the partnership is treated as a passive activity deduction to the lending partner, some or all of the interest received by the partner may be recharacterized as passive income under the self-charged interest rules.<sup>148</sup> If the partner borrows money and makes a capital contribution to the partnership, the interest is subject to the tracing rules, depending on how the partnership uses the money.

## INCOME FROM DISCHARGE OF INDEBTEDNESS<sup>149</sup>

Cancellation of debt (COD) income is includable in gross income except when excludable under IRC §108 (those rules are not within the scope of these materials).<sup>150</sup> Although a canceled debt may be a partnership debt, the COD rules are applied at the individual partner level, not at the partnership level.<sup>151</sup>

For partnerships, therefore, any gross income arising from COD must be allocated among the partners, who receive an increase in their partnership bases equal to their share of the COD income. Because there is also a corresponding reduction in partnership-level liabilities, the partners simultaneously are treated as receiving a constructive cash distribution for their respective shares of the liability reduction. These generally offset each other unless profits and losses are not shared in the same ratios. (Each partner will then determine whether their individual share of the COD income must be included in gross income or can be excluded under §108.) This means some partners may be able to exclude COD income, while others cannot.

**Example 22.** AB, LLC has two 50% members, Ashley and Barbara, who have equal allocations. The LLC has \$100,000 of COD income. Each of the members is therefore allocated \$50,000 of COD income and is simultaneously treated as receiving a \$50,000 cash distribution attributable to the LLC's reduction in liabilities.

Each member's partnership basis increases by \$50,000 for the pass-through COD income and decreases by \$50,000 for the reduction in liabilities. The net change is therefore zero.

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<sup>147</sup>. IRS Pub. 550, *Investment Income and Expenses*.

<sup>148</sup>. Treas. Reg. §1.469-7.

<sup>149</sup>. IRC §§61(a)(12) and 108. See also Rev. Rul. 2012-14, 2012-24 IRB 1012.

<sup>150</sup>. IRC §61(a)(12).

<sup>151</sup>. Rev. Rul. 2012-14, 2012-24 IRB 1012.



## NET INVESTMENT INCOME TAX<sup>152</sup>

The net investment income tax (NIIT) applies to investment income above certain thresholds. Income from partnerships is subject to this tax if the income is from a passive activity unless such income is subject to SE tax.<sup>153</sup> Income from Schedule K-1 is generally included on line 4a of Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*. Income from dispositions of property that are reported on Schedule K-1 is included on line 5a.

If the taxpayer **materially** participates in the trade or business of a partnership or is subject to SE tax on their distributive share, an adjustment must be made on lines 4b and 5b to subtract the pass-through income that is not subject to the NIIT.

**Example 23.** Sarah is a general partner in Newton Publishing, a general partnership. She works full time promoting its publications. Her 2016 Schedule K-1 showed ordinary income of \$990,000 and a net IRC §1231 gain of \$50,000 from the disposition of business assets. These were reported on lines 4a and 5a of Form 8960, respectively.

To show that these items of income were not subject to the NIIT, these amounts were reported on lines 4b and 5b and subtracted from the corresponding income. The relevant portion of Sarah's 2016 Form 8960 follows.

<b>Form 8960</b> <small>Department of the Treasury Internal Revenue Service (99)</small>	<b>Net Investment Income Tax— Individuals, Estates, and Trusts</b> <small>► Attach to your tax return.</small> <small>► Information about Form 8960 and its separate instructions is at <a href="http://www.irs.gov/form8960">www.irs.gov/form8960</a>.</small>	<small>OMB No. 1545-2227</small> <div style="font-size: 2em; font-weight: bold;">2016</div> <small>Attachment Sequence No. 72</small>
<small>Name(s) shown on your tax return</small> <b>Sarah Newton</b>		<small>Your social security number or EIN</small> <b>111-22-1111</b>
<b>Part I Investment Income</b> <div style="float: right;"> <input type="checkbox"/> Section 6013(g) election (see instructions)  <input type="checkbox"/> Section 6013(h) election (see instructions)  <input type="checkbox"/> Regulations section 1.1411-10(g) election (see instructions)         </div>		
<b>1</b> Taxable interest (see instructions) . . . . .	<b>1</b>	
<b>2</b> Ordinary dividends (see instructions) . . . . .	<b>2</b>	
<b>3</b> Annuities (see instructions) . . . . .	<b>3</b>	
<b>4a</b> Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions) . . . . .	<b>4a</b>	<b>990,000</b>
<b>b</b> Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions) . . . . .	<b>4b</b>	<b>(990,000)</b>
<b>c</b> Combine lines 4a and 4b . . . . .	<b>4c</b>	<b>0</b>
<b>5a</b> Net gain or loss from disposition of property (see instructions) . . . . .	<b>5a</b>	<b>50,000</b>
<b>b</b> Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions) . . . . .	<b>5b</b>	<b>(50,000)</b>
<b>c</b> Adjustment from disposition of partnership interest or S corporation stock (see instructions) . . . . .	<b>5c</b>	
<b>d</b> Combine lines 5a through 5c . . . . .	<b>5d</b>	<b>0</b>
<b>6</b> Adjustments to investment income for certain CFCs and PFICs (see instructions) . . . . .	<b>6</b>	
<b>7</b> Other modifications to investment income (see instructions) . . . . .	<b>7</b>	
<b>8</b> Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7 . . . . .	<b>8</b>	<b>0</b>
<b>Part II Investment Expenses Allocable to Investment Income and Modifications</b>		

**Note.** A partnership may be engaged in multiple activities. Some of those activities may be considered passive by definition (e.g., real estate rentals). In addition, a partner might materially participate in only one of multiple business activities engaged in by the partnership and may not have made a grouping election with respect to these activities. In these situations, a separate accounting of active and passive income is necessary for NIIT purposes. For more information about the **grouping election**, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

<sup>152</sup>. Instructions for Form 8960.

<sup>153</sup>. Treas. Regs. §§1.1411-5(a)(1) and 1.1411-9(a).



## DISPOSITION OF A PARTNERSHIP INTEREST

### HOLDING PERIOD

The selling partner's holding period for determining whether the capital portion of the gain or loss resulting from the disposition of a partnership interest is long- or short-term is determined without reference to the holding periods of the partnership's assets.<sup>154</sup> It is determined by how long the partner held the partnership interest. However, if the interest in the partnership was acquired as a result of a contribution of property to the partnership, the partner's holding period includes the holding period of the exchanged assets.<sup>155</sup>

### GAIN OR LOSS ON SALE OR EXCHANGE

The amount of gain or loss realized by the selling partner is equal to the difference between the amount realized and the selling partner's adjusted basis in the partnership interest.<sup>156</sup> The amount realized on the sale or exchange of a partnership interest is calculated as follows.

Money received	
+ FMV of property received	
+ <u>Reduction in the partner's share of partnership liabilities</u>	
Amount realized on sale or exchange	

**Example 24.** Mona has a basis in her partnership interest of \$30,000, which includes her \$20,000 share of partnership liabilities. She sells her entire partnership interest to Luann, an unrelated taxpayer, for \$15,000. The amount realized from the sale is calculated as follows.

Money received	\$15,000
Liabilities assumed by purchaser	<u>20,000</u>
Amount realized from the sale	\$35,000

In general, when a sale or exchange of a partnership interest occurs, any gain or loss must be recognized and treated as a capital gain or loss,<sup>157</sup> including proper application of the rates attributable to the portion of the gain from collectibles and unrecaptured IRC §1250 gains. However, if the partnership has any IRC §751 assets (unrealized receivables and substantially appreciated inventory) the sale must be reported as two sales: the §751 assets and the partnership interest.

IRC §751 assets are treated as ordinary income based on the difference between the amount realized from the §751 assets and the selling partner's **inside** share of the bases of those assets.<sup>158</sup> The portion of the sales price allocated to §751 assets may be specified in the agreement between the seller and purchaser. If no allocation is made, the relative FMV of the partnership's property is used.<sup>159</sup>

<sup>154</sup> *Comm'r v. Lehman*, 165 F.2d 383 (2d Cir. 1948); *Thornley v. Comm'r*, 147 F.2d 416 (3d Cir. 1945). See also *Comm'r v. Smith*, 173 F.2d 471 (5th Cir. 1949); *Kessler v. U.S.*, 124 F.2d 152 (3d Cir. 1941).

<sup>155</sup> IRC §1223(1).

<sup>156</sup> IRC §1001. See also Rev. Rul. 84-53, 1984-1 CB 159.

<sup>157</sup> IRC §741.

<sup>158</sup> Treas. Reg. §1.751-1(a)(2); and Rev. Rul. 75-323, 1975-2 CB 346.

<sup>159</sup> *Ibid.*

The term **unrealized receivables** includes income not previously recognized under the method of accounting used by the partnership for sales of inventory and services including contractual obligations for future sales.<sup>160</sup> The partnership's basis in the unrealized receivables includes all costs attributable to the income that have not been previously taken into account under the partnership's method of accounting.<sup>161</sup> The provisions regarding **substantially appreciated inventory** apply if at the time of the sale or distribution, the total FMV of all the inventory items of the partnership exceeds **120%** of the aggregate adjusted basis for such property (without regard to any special basis adjustment of any partner).<sup>162</sup>

The selling partner's basis in the assets is an amount equal to what the selling partner would have if their share of the properties was received in a current distribution immediately before the sale.<sup>163</sup> The basis includes any special adjustments available to the selling partner under IRC §§734(b) or 743(b).

**Note.** For more information on adjustments under IRC §§734(b) and 743(b), see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues.

## INSTALLMENT SALE METHOD

A sale of a partner's interest qualifies as an installment sale if at least one payment is received after the close of the tax year. When the partnership has §751 assets, the installment sale is more complicated. The portion of the sale allocated to §751 assets is **ineligible** for installment sale reporting and therefore must be reported in the year of sale.<sup>164</sup>

**Note.** For more information on the installment sale method, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Installment Sales. For more information on the installment sale method as applied to liquidations, see the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues.

## FAMILY GIFT OF A PARTNERSHIP INTEREST

### Background<sup>165</sup>

Family partnerships are subject to special rules to prevent income-shifting from high-income family partners to low-income family partners. The IRS may reallocate the income between the partners without regard to their respective capital interests if the partnership **does not meet certain tests**. The applicable tests depend on whether capital is a material income-producing factor in the business.

The determination that capital is the source of a material portion of the partnership's income is made based on the facts and circumstances related to the business. In general, capital is usually a **material income-producing factor** if the operation of the business requires substantial inventories or a substantial investment in land, plant, machinery, or other equipment. Farming is a business in which capital is a material income-producing factor.<sup>166</sup> Capital is **not** a significant factor if the income of the business consists principally of fees, commissions, or other compensation for services.

<sup>160</sup> IRC §751(c). See also *Wolcott v. Comm'r*, 39 TC 538 (1962).

<sup>161</sup> Treas. Reg. §1.751-1(c).

<sup>162</sup> Treas. Reg. §1.751-1(d).

<sup>163</sup> Treas. Reg. §1.751-1(a)(2); and Rev. Rul. 75-323, 1975-2 CB 346.

<sup>164</sup> Rev. Rul. 89-108, 1989-2 CB 100.

<sup>165</sup> IRC §704(e). See also Treas. Reg. §1.704-1(e).

<sup>166</sup> *Leo A. Woodbury et al. v. Comm'r*, 49 TC 180 (1967).

If **capital is a material income-producing factor**, the facts and circumstances must support the following.

1. The partners acquired their capital interests in a bona fide transaction (which includes gifts).
2. The partners actually own their purported interests.
3. The partners have dominion and control over their respective interests.

Additional rules apply when the partnership interest is gifted or sold to a family partner. Under these rules, the distributive share of partnership income is subject to both of the following restrictions.

- The distributable income must be reduced by reasonable compensation for services that the donor renders to the partnership.
- The distributive share of income allocated to the recipient of the gifted interest must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

**Note.** The presence or absence of a tax-avoidance motive is one of many factors to be considered in determining the ownership in a partnership interest acquired by gift.

If **capital is not a material income-producing factor**, the facts and circumstances must support the conclusion that the partners joined together in good faith to conduct a business. It is extremely important that any family partners performing significant services for the partnership receive adequate guaranteed payments in return.

## Gifted Interests

In general, there is no gain or loss on the transfer of a partnership interest by gift. The gift recipient's basis in the partnership interest is the donor's basis, subject to the usual adjustments for gifts.<sup>167</sup> The holding period for the donor carries over to the donee.<sup>168</sup> For gift and estate tax purposes, the value of the gift is the **FMV** of the transferred partner interest and not the basis of the transferred interest.<sup>169</sup>

However, if a gift of the partnership interest releases the donor from partnership liabilities, the gift is treated as a disposition.<sup>170</sup> The amount realized from the disposition includes the liabilities from which the donor was released.<sup>171</sup> If the amount realized is greater than the partner's basis, the result is a taxable gain.<sup>172</sup> However, if the amount realized is less than the partner's basis, the loss is not deductible.<sup>173</sup>

**Note.** This could also trigger a §743(b) basis adjustment of the partnership property for the gift recipient.

If only a portion of the partner interest is transferred, the reduction in the partner's share of partnership liabilities is treated as a cash distribution rather than as an amount received from a sale.<sup>174</sup> Therefore, the transferred liability reduces the donor's basis immediately before the gift.

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<sup>167</sup> IRC §1015.

<sup>168</sup> IRC §1223(2).

<sup>169</sup> *William H. Gross v. Comm'r*, 7 TC 837 (1946); *acq.*, 1946-2 CB 2.

<sup>170</sup> Treas. Reg. §1.1001-2(a)(4)(iii).

<sup>171</sup> Treas. Reg. §1.1001-2(a)(1).

<sup>172</sup> See Treas. Reg. §1.1001-2(c), Example 4.

<sup>173</sup> *Ibid.*

<sup>174</sup> Treas. Reg. §1.1001-1(c); IRC §752(b).

## Valuation of a Gifted Partnership Interest

The value of a partnership interest is the price a willing buyer would pay a willing seller in an arms-length transaction. The FMV of an interest may reflect marketability and minority discounts.<sup>175</sup>

**Note.** In August 2016, the IRS proposed significant changes<sup>176</sup> to the regulations governing these valuation discounts. The IRS received substantial push-back from commentators and Congress concerning the changes. As of August 14, 2017, no action has been taken on the proposals.

## ABANDONMENT OF A PARTNERSHIP INTEREST

When a partner abandons their interest and their portion of the liabilities is assumed by the remaining partners, the abandoner is deemed to sell their interest for their share of the liabilities.<sup>177</sup> This may result in either a capital gain or a loss.

**Example 25.** Travis is a general partner of Travis and Sons, LLP. He owns 75% of the partnership interests. Travis made the initial capital contribution to start the partnership, but his sons have been performing all the work. The partnership has shown continual losses, eroding Travis's entire basis. In addition, the partnership has a \$100,000 liability as the result of a bank loan. Travis is willing to give up his 75% ownership interest in order to avoid incurring additional losses and to be released from any liability for the bank loan. Travis must report \$75,000 ( $\$100,000 \times 75\%$ ) of income in the year of abandonment because he has no basis remaining in his ownership interest.

### Observations for Example 25

1. Travis's 75% share of the \$100,000 liability increased his basis, which has since been eroded. Because he previously received a tax benefit from claiming the losses, he must essentially reclaim those losses due to the release of the liability.<sup>178</sup>
2. The release of liabilities is treated as a distribution of money to the partner.<sup>179</sup> Accordingly, the tax consequences are determined under the rules applicable to distributions.

Other types of abandonment of a partnership interest are not a sale or exchange. If the abandonment results in a loss, it may be eligible for ordinary loss treatment.<sup>180</sup> A loss is considered ordinary only if there is neither an actual nor a deemed distribution to the partner.<sup>181</sup> Therefore, in a limited partnership in which all recourse liabilities are allocated to the general partners and there are no nonrecourse liabilities, a limited partner can abandon their interest and have an ordinary loss rather than a capital loss. This is not true for a general partner to whom recourse liabilities are allocated because giving up a recourse liability is treated as a deemed distribution.<sup>182</sup>

<sup>175</sup> Rev. Rul. 93-12, 1993-1 CB 202.

<sup>176</sup> Prop. Treas. Regs. §§25.2704-2 and 25.2704-4.

<sup>177</sup> IRS Pub. 541, *Partnerships*.

<sup>178</sup> See, e.g. *Comm'r v. Tufts*, 461 U.S. 300 (1983).

<sup>179</sup> IRC §752(b).

<sup>180</sup> *Citron v. Comm'r*, 97 TC 200 (Aug. 5, 1991).

<sup>181</sup> Rev. Rul. 93-80, 1993-2 CB 239.

<sup>182</sup> *Ibid.*

# 2017 Workbook