Chapter 5: Partnership 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.

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Chapter Summary

A partnership results when two or more persons participate in a common business activity. State laws and subchapter K of the Code regulate partnerships and LLCs. These rules govern relationships between the partners of the partnership and its relationship with the outside world. The partnership makes certain tax elections and files an information return reporting collective income and expenses and each partner's share of the same. Partners report their share of partnership income and expenses on their personal tax returns.

Certain unincorporated organizations can elect exclusion from subchapter K. An electing organization may nevertheless be subject to certain partnership regulations.

Most partnerships maintain capital accounts to determine each partner's economic investment in a partnership. The main distinction between capital and tax accounts concerns contributed assets, for which FMV is used for capital accounting purposes and basis is used for tax purposes.

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. At initial formation, the total inside bases of the partnership plus its liabilities equals the sum of the partners' outside bases. Differences between inside and outside bases can be eliminated by making a partnership election under IRC §754.

Generally, partners allocate items in proportion to their ownership interests. Special allocations that depart from this standard must have **substantial economic effect.** The determination of whether an allocation has substantial economic effect involves a 2-part analysis.

When there is a variation between the adjusted tax basis of contributed property and its FMV at the time of contribution, IRC §704(c) requires a partnership to specially allocate subsequent income, gain, loss, and deductions of the property entirely to the contributing partner until the difference is accounted for.

Generally, neither gain nor loss is recognized by the partnership or by the partners with respect to distributions. However, this may not apply to certain cash and property distributions, payments to a retired partner, and certain liquidating distributions.

A partnership normally terminates for federal tax purposes when it winds up its affairs and ceases conducting any business. However, a technical termination occurs when there is a 50% or more change in ownership in both partnership capital and partnership profits within a 12-month period. The tax consequences of partnership terminations are discussed.

[T]here can be little doubt that the attempt to achieve "simplicity" [in partnership taxation] has resulted in utter failure.[1]

THE NATURE OF PARTNERSHIPS

As a concept, a partnership is nothing more than two or more persons who have agreed to engage in a common business activity. Such an arrangement, however, results in two sets of relationships.

1. The relationship of the persons to each other within their common activity
2. The relationship of the activity to the rest of the world

Consequently, rules that determine the nature of each of these relationships are required. For purposes of state law, the rules are in statutes governing partnerships and limited liability companies (LLCs); for federal tax purposes, they are in subchapter K of the Code.

Under state law, the statutory rules governing the internal relationships of the partners to each other are default rules. They are applicable in the absence of an agreement by the partners. Therefore, stating that "there is no partnership because there is no partnership agreement" is incorrect. If a relationship looks and acts like a partnership under state law, it is a partnership. The absence of a specific partnership agreement among the partners means only that state law controls their internal relationship both for state law purposes[2] and for tax purposes.[3]

The external relationship of the partnership or LLC to the rest of the world is a different matter. Under traditional partnership law, each general partner has full, unlimited liability for any wrong or injury committed by the partnership, even if the general partner had nothing to do with that act. Each general partner is liable for payment of the full amount of any partnership liability to third parties, not just the share attributable to their partnership interest. The LLC entity structure eliminates the unlimited liability exposure general partners have. Each member of an LLC has liability exposure only for harm done by that member. This is the same liability protection shareholders of a corporation have in their capacity as shareholders. At the same time, LLC members enjoy the flexibility of partnerships to privately agree what rules govern their internal relationship. Corporations are much more limited in this respect.

For federal tax purposes, there is no distinction between partnerships and LLCs that are taxed as partnerships under the classification regulations.[4] Both are subject to the partnership tax provisions of subchapter K. In this chapter, both partnership partners and LLC members are generally referred to as "partners."

> **Note.** The default tax status of a multiple-member LLC is a partnership. A single-member LLC is generally taxed as if the sole member owns the assets directly. However, an LLC may elect to be taxed as a corporation.

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1. The Tax Court commenting on Congress's attempt in 1954 to achieve simplicity in partnership taxation through enacting Subchapter K. *Foxman, et al. v. Comm'r,* 41 TC 535 (1964), *aff'd* 352 F.2d 736 (3rd Cir. 1965), *acq.* 1966-2 CB 4.
2. *Uniform Partnership Act (1997)* National Conference of Commissioners on Uniform State Laws. [www.uniformlaws.org/shared/docs/partnership/upa_final_97.pdf] Accessed on Jun. 6, 2017.
3. Treas. Reg. §1.761-1(c).
4. Treas. Reg. §301.7701-3.

DEFINING PARTNERSHIPS

The Uniform Partnership Act defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit. . . "[5] The Code defines a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation."[6] Whether an entity is a partnership for income tax purposes is determined under federal tax law, which may be broader than comparable state law.

The tax rules applicable to partnerships may be described as **"aggregate"** or **"entity."**[7] The **aggregate theory** of partnership taxation is that of the collective sole proprietorship. That is why it is impossible to have an income tax liability at the partnership level. Instead, each partner is required to report their share of the collective income and expenses on their own individual Form 1040, *U.S. Individual Income Tax Return,* as if each of them had individually earned the income or made the expenditures. In fact, the Form 1065, *U.S. Return of Partnership Income,* is not an income tax return; instead, it is an information return.[8]

Because each partner must report their share of all partnership items and because the partnership's internal operation is determined internally on the basis of the partners' agreement among themselves, the partners have the ability to use their agreement to determine how income tax items, such as depreciation deductions, are allocated among the partners. Much of the complexity of the partnership tax rules, therefore, comes from efforts by Congress and the IRS to prevent partnerships from using their freedom of contract to make allocations among partners that are based on tax avoidance. This is the purpose, for example, of the requirement that special allocations have substantial economic effect.[9]

Under the **entity theory,** partnerships are treated as **entities** for tax purposes. This is generally done for purposes of administrative convenience or to ensure consistency among the partners. Thus, tax elections (e.g., whether to expense under §179) must be made at the partnership level.

Because of the lack of a precise definition of partnerships and the often informal partnership arrangements, the determination of whether an arrangement is a partnership may require a facts-and-circumstances analysis. The classification regulations **may** treat an arrangement of two or more persons as a separate entity if the participants carry on a trade, business, financial operation, or venture and divide the profits from that activity.[10] Courts have considered the following factors, none of which is conclusive. [11]

- The agreement of the parties and their conduct in executing its terms
- The contributions, if any, that each party makes to the venture
- Parties' control over income and capital and the right of each to make withdrawals
- Whether each party is a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving contingent compensation for services in the form of a percentage of income
- Whether business was conducted in the joint names of the parties

5. *Uniform Partnership Act (1997).* National Conference of Commissioners on Uniform State Laws. [www.uniformlaws.org/shared/docs/partnership/upa_final_97.pdf] Accessed on Jun. 6, 2017.
6. IRC §7701(a)(2).
7. See. e.g., *Holiday Village Shopping Center, Inc. v. U.S.,* 773 F.2d 276 (Fed. Cir. 1985).
8. IRC §6031 requiring partnership returns is found in the Code under *Information Returns* at Subtitle F, Chapter 61, Subchapter A, Part III.
9. Treas. Reg. §1.704-1(b)(2).
10. Treas. Reg. §301.7701-1(a)(2).
11. *Luna v. Comm'r,* 42 TC 1067 (1964).

- Whether the parties filed federal partnership returns or otherwise represented themselves as partners to the IRS or to other people with whom they dealt
- Whether separate books of account were maintained for the venture
- Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise

In cases and rulings concerning whether an arrangement constitutes a partnership, the principal focus has been on whether the parties operated under an arrangement in which there was a division of profits from the venture. Nevertheless, as one court stated, "the sharing of profits is a necessary, but not sufficient, condition for a finding that a joint venture exists."[12] In that case, the court determined that a sharing of **gross receipts** from vending machines with the owners of establishments in which the machines were located was not a partnership because a sharing of gross receipts alone was not the sharing of profits. The term "profit" requires a sharing of **both** receipts and expenses.

CO-TENANCIES

Mere co-ownership of property or cost-sharing arrangements does not create an entity for classification purposes.[13] Instead, the joint ownership or arrangement must be for purposes of using the co-owned property or other arrangement to carry on a trade, business, financial operation, or venture, and dividing the profits from that activity. Even if an arrangement is not treated as an entity for classification purposes, if the participants in the arrangement nevertheless file partnership returns (which they are not prohibited from doing), they generally are prohibited from denying they are a partnership. In one letter ruling, for example, filing partnership returns evidenced intent to form a partnership. This prevented individual co-owners from engaging in like-kind exchanges of tenancies in common because the IRC §1031 like-kind exchange rules apply at the partnership level.[14]

The fact that services may be provided to tenants of the property is an issue only if provided by the co-owners. In one case, for example, two co-owners of apartment units provided customary tenant services to tenants of the apartments through a third-party manager. The manager also provided additional services, such as attendant parking, cabanas, gas, electricity, and other utilities. This was done independently by the manager, however, who kept all of the fees earned for such services. Because the services were provided independently of apartment rentals by the co-owners, the agent's activities were found not to be sufficiently extensive to cause the co-ownership to be considered a partnership.[15] Although a division of profits is normally thought of as a division of cash profits, courts have held that in-kind divisions of a product of an arrangement is within the scope of division of profits. In one leading case, a utility owned an interest in a nuclear power plant as a tenant in common with two other utilities and the two utilities shared the power generated. This was held to be a partnership, not a co-tenancy.[16]

If an arrangement is not an entity required to be classified as a partnership, the individual co-owners each report their proportionate share of income and expenses on their respective individual returns. In the case of individual co-owners, for example, each would report their share of income and expenses on Schedule E, *Supplemental Income and Loss.*

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12. *ACME Music Company, Inc. v. IRS,* 196 BR 925 (BR WD Pa 1996).
13. Treas. Reg. §301.7701-1(a)(2).
14. Ltr. Rul. 9741017 (July 10, 1997).
15. Rev. Rul. 75-374, 1975-2 CB 261.
16. *Madison Gas and Electric Company v. Comm'r,* 633 F.2d 512 (7th Cir 1980), *aff'g* 72 TC 521 (1979).

Effect of Holding Real Estate in an LLC

In order for the co-ownership exception to the creation of a partnership to apply, it is the IRS's position that real estate must be titled in the names of the individual co-owners either directly or indirectly through a disregarded entity. Title to the property as a whole may not be held by an entity recognized under local law if it has more than one member.[17] Thus, if rental real estate is titled in the name of an LLC with more than one member, the IRS treats the activity as a partnership requiring the filing of a partnership return.

There is nothing in the classification regulations or — with one exception — in anything issued by the IRS that permits a husband-wife LLC to be treated as a disregarded entity on a joint return. The one exception is applicable only to spouses in community property states when all the interests in an LLC are owned solely by the husband and wife as community property. In those cases, the spouses may choose to treat the LLC either as a disregarded entity or as a partnership (and file partnership returns). The IRS accepts that choice.[18]

ELECTING OUT OF SUBCHAPTER K

IRC §§701–777 comprise subchapter K and generally govern the tax treatment of partnerships (although §§771–777 apply to electing large partnerships and generally do not affect practitioners). IRC §761(a) gives the IRS authority to issue regulations permitting members of an unincorporated organization to be excluded from all or part of subchapter K. The income of the organization's members must be capable of being adequately determined without the need for computing partnership taxable income.[19] The following organizations are eligible for this treatment.[20]

1. Those formed for investment purposes only and not for the active conduct of a business
2. Those formed for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted
3. Those formed by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities

The first type of organization is the one most commonly encountered by practitioners. The second is intended primarily for public utilities.

The regulations have the following requirements for an investment partnership to elect exclusion from subchapter K.[21]

1. The participants must be involved in the joint purchase, retention, sale, or exchange of investment property.
2. They must own the property as co-owners.
3. Each participant must reserve the separate right to take or dispose of their shares of any property acquired or retained.
4. The participants must not actively conduct business or irrevocably authorize some person or persons as representatives to purchase, sell, or exchange the investment property. However, participants may delegate authority to purchase, sell, or exchange their share of any investment property for a period of not more than one year.

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17. See, e.g., Rev. Proc. 2002-22, 2002-1 CB 733 (§6.01).
18. Rev. Proc. 2002-69, 2002-2 CB 831.
19. Treas. Reg. §1.761-2(a)(1).
20. IRC §761(a).
21. Treas. Reg. §1.761-2(a)(2).

5. The organization must make an affirmative election to be excluded or must be deemed to have made an election to be excluded.

RENTAL REAL ESTATE PARTNERSHIPS AND ELECTING OUT

Although it may be common for rental real estate partnerships to file elections under §761 to be excluded from subchapter K, it is doubtful that many such elections are valid, especially in the case of LLCs. As stated above, two requirements for the election are co-ownership of the property and the right of each participant to take or dispose separately of their share of the property. If the property is titled in the name of an entity, it is not co-owned directly by the co-owners. Instead, they own an interest in the entity. The only authority in this area comes from a few letter rulings.

In one field service advice (FSA), the IRS considered whether rental real estate held in a limited partnership was eligible for exclusion under §761.[22] The IRS stated that the determination of co-ownership must be made under state law by reference to each party's rights in the property as specified by a lease or other contract between the parties. Limited partners are treated under state law as owning partnership interests in a limited partnership, which is treated as personal property. They do not directly own property and cannot separately take or dispose of assets owned by the limited partnership itself. A limited partnership is therefore not eligible to elect exclusion from subchapter K. This result is not affected by any statement in the limited partnership agreement purporting to characterize the partnership as an investment partnership electing to be excluded under §761. Although not addressed in the FSA, the same principle is applicable to LLCs or any other state-law form of partnership holding separate title to rental real estate.

In a private letter ruling, the IRS ruled that investment real estate owned by tenants in common was a partnership not eligible for exclusion under §761.[23] Property owned by the co-owners was desired by several potential purchasers. The owners did the following.

- They entered into an agreement with a third-party agent to act for them in selling or otherwise disposing of the property.
- They required any actions relating to the property to be approved by majority vote of the total undivided interests in the property.
- Transfers of interests in the property were restricted to certain listed related parties, with any other transfers requiring prior written consent of all of the other owners.
- Partition of the property was prohibited during the term of the agreement.

The IRS ruled that the effect of the agreement was a surrender by the parties of their rights to take and separately sell their respective shares of the property so that the venture became more than mere co-ownership of property and was therefore properly classified as a partnership.

22. FSA 200216005 (Jan. 10, 2002).

23. Ltr. Rul. 8002111 (Oct. 22, 1979).

EFFECT OF ELECTING OUT

The IRS has the authority to exclude an electing partnership from the provisions of all or a portion of subchapter K.[24] The IRS stated in two revenue rulings that the election out does **not apply** to §704(d) for purposes of prohibiting partners from deducting losses in excess of their basis in the partnership.[25] In addition, the election out does not eliminate the need to establish a business purpose under §706(b) for adoption of a tax year for the partnership different from that of its principal partners.[26]

When an organization elects out of subchapter K pursuant to §761, it is generally not treated as a partnership **only** for purposes of those partnership rules specifically found in subchapter K. This means, for example, that a participant who sells their interest in an organization that has elected out is not treated as having sold a partnership interest, which would be considered the sale of a capital asset. This sale is also not subject to ordinary income recharacterization under §751 for certain items, such as cash-basis receivables. Instead, the participant is treated as having sold a proportionate interest in each asset held by the organization and is required to characterize and report gain or loss accordingly.[27]

It has long been the IRS's position, as sustained by the courts, that the election out of subchapter K means only that those provisions are not applicable to the electing organization. However, for all other purposes of the Code, the organization is still a partnership to the extent required for proper application of the tax laws. As the Tax Court stated in *Bryant v. Comm'r*:

> *The election under section 761(a) does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.*[28]

Consequently, in applying provisions not contained in subchapter K to an electing partnership, there must be some other basis for asserting that the entity is not a partnership. For example, partnership interests are not eligible for like-kind exchange nonrecognition treatment under IRC §1031. If an investment partnership holding real estate does not elect out of subchapter K, it is still treated as a partnership under §1031. This means that only the entity can accomplish the like-kind exchange because no individual partner can accomplish a like-kind exchange of the partner's outside interest. IRC §1031(a)(2) provides, however, that "For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership."

Whether the organization should be treated as a partnership under other Code provisions is determined, according to the IRS, by whether the other provision and the provisions of subchapter K are "interdependent." If there is interdependency, the organization is treated as a partnership; if not, each partner is treated as directly owning an interest in the assets. The IRS discussed interdependence in a General Counsel Memorandum (GCM), stating that:

> *Merely because a partnership elects not to be subject to the provisions of subchapter K, does not mean that the partnership can escape limitations generally applicable to partnerships if those limitations can be applied despite the fact that income and deductions are computed at the partner rather than the partnership level. The question in each instance is whether the limitation or rule outside of subchapter K can be applied without doing violence to the concept of electing out of subchapter K and computing income and deductions at the partner level.*[29]

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24. IRC §761(a).
25. Rev. Rul. 58-465, 1958-2 CB 376.
26. Rev. Rul. 57-215, 1957-1 CB 208.
27. TAM 9214011 (Dec. 26, 1991).
28. *Bryant v. Comm'r,* 46 TC 848 (1966), *aff'd* 399 F.2d 800 (5th Cir. 1968).
29. GCM 39043 (Oct. 5, 1983).

The discussion in the GCM expressly rejected a position in a proposed revenue ruling that interdependence exists only when a provision outside of subchapter K imposes a procedural or substantive rule specifically applicable to partnership entities. The GCM unhelpfully concluded that "Perhaps at this point, however, it is unnecessary to get involved in explaining the concept of interdependence."

Despite this lack of clear definition, no case or ruling has used interdependence in the absence of a particular Code provision intended to apply at the partnership level. For example, the Tax Court in *Bryant v. Comm'r* held that individual partners of a partnership that elected out of subchapter K were not each entitled to $50,000 of investment tax credit. Instead, the partners must share proportionately in the single $50,000 investment tax credit permitted partnerships with respect to partnership assets.[30] Existing cases and rulings have addressed interdependency in the following situations involving an election out of subchapter K.

- Partners are still required to treat their distributive share of partnership business income as net earnings from self-employment to the extent required under IRC §1402.[31]
- Individual partners may elect separately to treat their share of mine development costs as currently deductible or as deferred expenses under IRC §616(b) if the partnership elected out of subchapter K.[32]
- The partnership unified audit (under the Tax Equity and Fiscal Responsibility Act) procedures of IRC §6231 are not applicable to partnerships that properly elect out of subchapter K. Any audit involving such an organization must be based upon the books and records of each individual partner, who must substantiate their share of the items reported for income tax purposes.[33]

> **Note.** Presumably, the same principle will continue to apply under the new partnership audit rules effective beginning January 1, 2018.

- Partners of an electing partnership are treated as directly owning undivided interests in the partnership assets for purposes of determining the depreciation method to be used for its interest. The anti-churning rules are applicable at the individual partner level.[34]
- A partner of an electing partnership is entitled to an IRC §165 abandonment loss when it abandons its proportionate interest in property of the partnership rather than when the partnership abandons the property.[35]
- For purposes of extensions of time for payment of estate tax under §6166A, an interest in a partnership that has elected out of subchapter K is still considered an interest in a partnership that is a closely held business and not an interest in the assets themselves.[36]

30. *Bryant v. Comm'r,* 46 TC 848 (1966), *aff'd* 399 F.2d 800 (5th Cir. 1968).
31. *Cokes v. Comm'r,* 91 TC 222 (1988).
32. Rev. Rul. 83-129, 1983-2 CB 105.
33. FSA 001917 (Jan. 31, 2004).
34. TAM 9504001 (Jun. 10, 1994).
35. TAM 9214011 (Dec. 26, 1991).
36. TAM 8042011 (July 1, 1980).

There is no direct guidance addressing the impact on §179 expensing of an election out of subchapter K. IRC §179(d)(8) states that the dollar limitation (amount that can be expensed) and taxable income limitation (taxpayer income against which expensed amounts are deductible) are applied at the entity level for partnerships. This is similar to the situation in the *Bryant* case (mentioned previously), in which the Tax Court applied the investment tax credit limitation at the partnership level for an electing organization. Because there is a specific limitation applicable to partnerships, partners in an organization electing out of subchapter K are limited to their proportionate shares of any dollar amount that can be expensed by the partnership.

How the taxable income limitation applies is not clear. Presumably, any aggregate amount expensed by the partners in excess of the partnership taxable income carries forward at the partnership level to be used in future years under the partnership rules, notwithstanding the election out of subchapter K.

MAKING THE ELECTION

The regulations generally require an affirmative election under §761(a).[37] The election must be filed no later than the due date (including extension) of the partnership return for the first year for which the exclusion is desired. Thus, it can be filed even for an entity that has been filing partnership returns. Once made, the election is irrevocable without the IRS's consent. The election is made by filing a Form 1065 partnership return at the proper IRS Service Center. The return should include only the following.

- The name or other identification and the address of the organization
- A statement attached to the return showing the names, addresses, and taxpayer identification numbers of all the members of the organization
- A statement that the organization qualifies for exclusion under one of the categories of IRC §761(a)
- A statement that all members of the organization elect to be excluded from subchapter K
- A statement indicating where a copy of the agreement under which the organization operates is available or, if the agreement is oral, from whom the provisions of the agreement may be obtained

The regulations also permit a **deemed election** in the event no affirmative election is filed. This is available if it can be shown from all relevant facts and circumstances that it was the intention of the members of the organization at the time of its formation to be excluded from subchapter K beginning with the first tax year of the organization. The regulations list the following two nonexclusive factors that may indicate the requisite intent.[38]

1. At the time of formation, there is an agreement among the members that the organization will be excluded from subchapter K beginning with its first tax year.
2. The members of the organization owning substantially all of the capital interests report their respective shares of the income, deductions, and credits of the organization on their returns, making such elections as to individual items as may be appropriate, in a manner consistent with the exclusion of the organization from subchapter K beginning with the organization's first tax year.

If it is found that an election out of subchapter K was not proper, the consequences may be unpleasant. One field service advice states that "If the entity did not **properly** elect out of subchapter K, then it is still required to file partnership returns [emphasis added]."[39] Presumably, the partnership is then required to file late partnership returns, which could subject the partners to significant penalties unless the IRS can be convinced there is reasonable cause for abatement.

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37. Treas. Reg. §1.761-2(b).
38. Treas. Reg. §1.761-2(b)(2)(ii).
39. FSA 001917 (Oct. 8, 1996).

CAPITAL ACCOUNTS

Capital accounts are used to measure a partner's economic investment in a partnership as opposed to tax investment. **Capital accounts are commonly referred to as "book" accounts** to distinguish them from tax capital accounts. The principal difference between the two is that book capital accounts are based on the fair market value (FMV) of contributed assets,[40] while tax accounts use the basis of contributed assets.[41] In this section, the term "capital account" refers to "book" unless stated otherwise.

Although the maintenance of capital accounts is intended to track the partners' economic interests in a partnership, these accounts are generally adjusted with respect to tax items, rather than through the use of normal financial accounting rules. This is because the fundamental rule of partnership allocations is that tax allocations must follow book allocations.[42] In addition, special rules are provided under IRC §704(c) (described in the section entitled "IRC §704(c) Allocations") for contributions of property with a book value that differs from its tax basis because, in these instances, tax allocations and book allocations necessarily differ.

Each partner's book capital account begins at zero and, in general, is **increased** by the following items.[43]

- The amount of money contributed by the partner to the partnership
- The FMV of property contributed by the partner to the partnership, net of liabilities secured by such contributed property that the partnership is considered to assume or take under IRC §752
- Allocations to the partner of partnership income and gain, including tax-exempt income and certain special allocations required by the regulations

The following items **decrease** book capital accounts.[44]

- The amount of money distributed to a partner by the partnership
- The FMV of property distributed to the partner net of liabilities secured by the distributed property that the partner is considered to assume or take under §752
- Allocations to the partner of nondeductible, noncapital expenditures of the partnership
- Allocations of partnership loss and deductions

A partner who has more than one interest in a partnership is required to have a single book capital account that combines all interests of the partner in the partnership.[45]

Many rules must be followed in maintaining book capital accounts. These are generally found in Treas. Reg. §§1.704-1(b)(2)(iv)(c)–(q). The rules are briefly described in the following material (noncompensatory options are omitted).

A summary of the changes to a partner's capital account is reported on Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* in box L. Method used to calculate these amounts are described separately.

Box M of Schedule K-1 indicates if the partner contributed property with a built-in gain or loss subject to IRC §704(c). The relevant portion of the Schedule K-1 is shown next.

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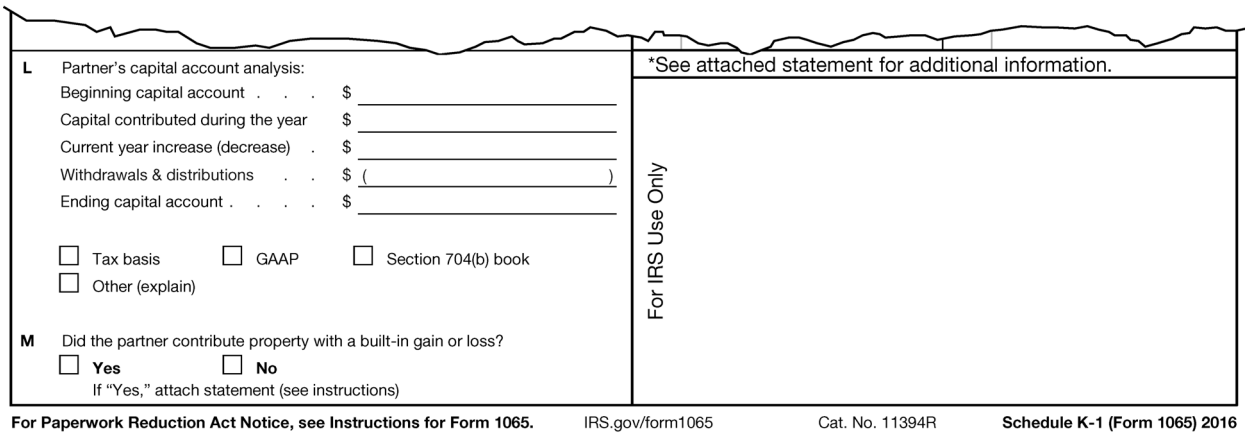
40. See, e.g., Treas. Reg. §§1.704-1(b)(2)(iv)(b) and 1.704-1(b)(2)(iv)(g).
41. IRC §722.
42. Treas. Reg. §1.704-1(b)(2)(ii).
43. Treas. Reg. §1.704-1(b)(2)(iv)(b).
44. Ibid.
45. Ibid.



L Partner's capital account analysis:
Beginning capital account . . . $
Capital contributed during the year $
Current year increase (decrease) . $
Withdrawals & distributions . . $ ( )
Ending capital account . . . . $

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

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

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2016

LIABILITIES[46]

For book purposes, money contributed by a partner to a partnership includes the amount of any partnership liabilities assumed by the partner other than liabilities assumed by a distributee-partner in connection with distributed property. Money distributed to a partner by a partnership includes the amount of the partner's individual liabilities that are assumed by the partnership other than liabilities secured by contributed property. Liabilities are considered assumed only to the extent:

- The assuming party is subjected to personal liability,
- The obligee is aware of the assumption and can directly enforce the assuming party's obligation, and
- The assuming party is ultimately liable (rather than the party from whom the liability is assumed).

Liabilities do not include constructive cash distributions and partner contributions resulting from liability shifts occurring as a result of contributions and distributions of encumbered property.

FAIR MARKET VALUE[47]

The FMV assigned to property by the partners is generally accepted for book purposes as long as the value is reasonably agreed to among the partners in arm's-length negotiations and the partners have sufficiently adverse interests. If these conditions are not satisfied and the property values are overstated or understated by more than an insignificant amount, the partners' capital accounts are not considered to satisfy the economic effect requirement (other than economic equivalence).[48] FMV is determined without taking into account the §7701(g) requirement that the FMV of property securing a nonrecourse liability is not treated as less than the amount of the nonrecourse liability.

PROMISSORY NOTES

A partner's contribution of a promissory note does not result in any increase in the partner's book account unless the partnership disposes of the note in a taxable transaction or payments are actually made against the note principal by the contributing partner.[49] If the note is readily tradable on an established securities market, however, this limitation is not applicable.[50] Similarly, a partner's capital account is not decreased for distribution of a partnership's note to a partner unless there is a taxable disposition of the note by the partner or the partnership makes principal payments.[51]

46. Treas. Reg. §1.704-1(b)(2)(iv)(c).
47. Treas. Reg. §1.704-1(b)(2)(iv)(h)(1).
48. Ibid.
49. Treas. Reg. §1.704-1(b)(2)(iv)(d)(2).
50. Ibid.
51. Treas. Reg. §1.704-1(b)(2)(iv)(e)(2).

IRC §704(c) CONSIDERATIONS

The partnership agreement must require that the partners' capital accounts be adjusted to reflect differences between book value and tax basis with respect to contributed property subject to a §704(c) special allocation for precontribution gain or loss.[52] The capital accounts **are not adjusted,** however, to reflect the actual tax allocations required under §704(c).[53]

DISTRIBUTED PROPERTY

A partner's capital account is decreased by the FMV of property distributed to the partner. In doing so, the capital accounts of all the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in the property that has not previously been reflected in capital accounts would be allocated among the partners if there were a taxable disposition of the property for its FMV.[54] For this purpose, the excess of nonrecourse liabilities over FMV is taken into account.[55]

Revaluations of Partnership Property

A partnership agreement may increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books, including intangible assets such as goodwill.[56] For revaluations to be acceptable, they must be made principally for a substantial nontax business purpose such as any of the following.[57]

- The admission of a new partner
- Contributions by existing partners
- The liquidation of the partnership or a distribution of money or other property to a retiring or continuing partner as consideration for an interest in the partnership
- Issuance of a partnership interest to an existing or new partner in exchange for services performed to the partnership
- In connection with the issuance by the partnership of a noncompensatory option
- Under generally accepted industry accounting practices, if substantially all the partnership's property is readily tradable stock, securities, etc.

In addition, the partnership agreement must generally require that the capital accounts be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in the property would be allocated among the partners under §704(c) special allocation principles if there were a taxable disposition of the property for FMV on the date of distribution.[58]

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52. Treas. Reg. §1.704-1(b)(2)(iv)(d)(3).
53. Ibid.
54. Treas. Reg. §1.704-1(b)(2)(iv)(e)(1).
55. Ibid.
56. Treas. Reg. §1.704-1(b)(2)(iv)(f).
57. Treas. Reg. §§1.704-1(b)(2)(iv)(f)(5)(i)–(v).
58. Treas. Reg. §§1.704-1(b)(2)(iv)(f)(1)–(4).

SPECIAL ADJUSTMENTS TO REFLECT BOOK VALUE

One of the goals of the substantial economic effect test (discussed in the section entitled "Substantial Economic Effect Requirement") is to apply economic rules to a partnership's bookkeeping that will, over time, eliminate the differences between the partnership's tax values (basis) and its book values (FMV). This is also a purpose of the mandatory §704(c) special allocations with respect to precontribution gain or loss. Allocations to the partners of depreciation, depletion, amortization, and gain or loss for book purposes must therefore be made for the book value of the property using the same ratio as the corresponding tax item over the tax basis of the property.[59] For depreciation and other amortization purposes, if the property has a zero tax basis, the corresponding book deduction may be determined under any reasonable method selected by the partnership.[60]

Example 1. A partner contributes property with an FMV of $90 and an adjusted basis of $60 to a partnership. The depreciation deduction for the first year following the contribution is $20, which is one-third of the adjusted basis of the property. For purposes of book accounting, the partnership is therefore required to depreciate one-third of the $90 book value, or $30.

NONDEDUCTIBLE EXPENDITURES[61]

Nondeductible, noncapital expenditures of the partnership (e.g., the 50% disallowance of meal and entertainment expenses) reduce a partner's book account. Unless an election is made under IRC §709(b) to amortize organizational expenditures, they are treated as nondeductible, noncapital expenses. Losses that are disallowed under IRC §§267 or 707(b) for sales or exchanges of partnership property to related parties are also treated as such expenditures.

DEPLETION

Depletion deductions are separately stated items for income tax purposes. For book accounting, however, the regulations require that "simulated" depletion be determined at the partnership level and be used to adjust book value without regard to the tax limitations that apply at the individual partner level. Alternatively, each partner's actual depletion deduction can be used. [62]

TRANSFERS OF PARTNERSHIP INTEREST

Upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest must carry over to the transferee-partner. If the transfer of an interest in a partnership causes a termination of the partnership under IRC §708, the capital account of the transferee-partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that results from termination of the prior partnership. Moreover, the deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur as a result of the change in ownership are disregarded for purposes of book accounting.[63]

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59. Treas. Reg. §§1.704-1(b)(2)(iv)(g)(1) and (3).
60. Treas. Reg. §1.704-1(b)(2)(iv)(g)(3).
61. Treas. Reg. §1.704-1(b)(2)(iv)(i).
62. Treas. Reg. §1.704-1(b)(2)(iv)(k).
63. Treas. Reg. §1.704-1(b)(2)(iv)(l).

OPTIONAL BASIS ADJUSTMENTS

A partnership that has an IRC §754 election in effect is generally not permitted to adjust the book account of a transferee-partner or of the partnership in the case of an IRC §743 adjustment under which a transferee-partner adjusts the partner's share of inside tax basis to reflect the outside tax basis.[64] This does not apply, however, to the extent the basis adjustment is allocated to the common basis of partnership property.[65] IRC §732(d) adjustments for partnerships that do not have a §754 election in effect are treated in the same manner.[66]

> **Note.** IRC §754 elections and §743 adjustments are discussed later in the chapter.

If there is an adjustment under IRC §734 (discussed later) as a result of gain or loss being recognized by a distributee-partner upon distribution of property from the partnership, the partner receiving the distribution giving rise to the adjustment is required to have a corresponding adjustment made to their book account.[67] If the distribution is made other than in liquidation of the partner's interest, however, the capital accounts of all partners are adjusted. The adjustment should be made in the manner in which the unrealized income and gain that is displaced by the adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to the adjustment for its recomputed adjusted tax basis.[68]

A partner's capital account may be adjusted for IRC §§732, 734, and 743 basis adjustments to partnership property but only to the extent that such basis adjustments are permitted to partnership property under IRC §755 and result in a change in the amount for such property on the partnership's balance sheet for book purposes.[69]

PARTNERSHIP LEVEL CHARACTERIZATION

Except as otherwise required for depletion, the book capital accounts of partners must be determined by applying federal tax rules at the partnership level without regard to how items would be required to be treated at the individual partner level. In other words, book accounting treats the partnership as an entity rather than as an aggregate.[70]

64. Treas. Reg. §1.704-1(b)(2)(iv)(m)(2).
65. Ibid.
66. Treas. Reg. §1.704-1(b)(2)(iv)(m)(3).
67. Treas. Reg. §1.704-1(b)(2)(iv)(m)(4).
68. Ibid.
69. Treas. Reg. §1.704-1(b)(2)(iv)(m)(5).
70. Treas. Reg. §1.704-1(b)(2)(iv)(n).

GUARANTEED PAYMENTS

Guaranteed payments to a partner under IRC §707(c) cause the capital account of the recipient partner to be adjusted only to the extent of the partner's distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.[71]

Example 2. ABC Partnership has three partners. All partnership items are allocated in accordance with the partners' percentage interests. The partners have the following ownership interests, tax bases, and capital accounts.

Partner	Percentage	Basis	Capital Account
Avery	80	$80,000	$80,000
Basil	15	15,000	15,000
Carlita	5	5,000	5,000

Carlita receives a $10,000 guaranteed payment. Each partner is allocated their respective share of deduction for the guaranteed payment, which reduces their capital accounts accordingly.

Partner	Percentage	Deduction	Capital Account
Avery	80	$8,000	$72,000
Basil	15	1,500	13,500
Carlita	5	500	4,500

Thus, Carlita receives $10,000 but her capital account is reduced by only her $500 share of the partnership's deduction for the payment.

MINOR DISCREPANCIES

Minor discrepancies between the actual balances in the capital accounts of the partners and the balances that would have existed had the book accounting rules been properly followed are not treated as violating the substantial economic effect requirement as long as they are attributable to good faith error by the partnership.[72]

ADJUSTMENTS WHEN GUIDANCE IS LACKING

If the regulations fail to provide guidance on how adjustments to capital accounts should be made with respect to particular items, then adjustments must be made in a manner that:[73]

1. Maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes;
2. Is consistent with the underlying economic arrangement of the partners; and
3. Is based, whenever practicable, on federal tax accounting principles.

71. Treas. Reg. §1.704-1(b)(2)(iv)(o).
72. Treas. Reg. §1.704-1(b)(2)(iv)(p).
73. Treas. Reg. §1.704-1(b)(2)(iv)(q).

TAX BASIS VS. BOOK ACCOUNTING

Is it possible simply to use tax basis accounting for a partnership and skip capital accounts? The short answer is yes. In fact, many small partnerships do not maintain capital accounts and there may be no need for them to do so. Regardless of whether capital accounts are maintained, tax basis accounting is required.

The fundamental purpose of using both capital accounting and tax accounting is to enable partners to track any differences between their economic and tax investments in a partnership. This may become important when the two differ because of the possibility of creating undesirable tax issues.

Take, for example, the rules governing contributions of property with built-in gain or loss under §704(c) (discussed in the "IRC §704(c) Allocations" section). If a partner contributes property with built-in gain, it is mandatory that the built-in gain be specially allocated to the contributing partner if the property is sold or exchanged in a taxable transaction, with only post-contribution appreciation in value allocated among all the partners. This ensures that a contributing partner cannot avoid paying tax on appreciated property by contributing it to a partnership. Even if the property is not sold, there are complicated regulations requiring the book-tax disparity to be eliminated as quickly as possible. Maintaining capital accounts helps identify such situations and avoid problems.

Example 3. Ava and Brian form an equal partnership. Ava contributes $100 cash and Brian contributes property with an FMV of $100 and an adjusted basis of $40. Each has a $100 capital account, because Brian's capital account is equal to the property's FMV. Ava has $100 of partnership basis and Brian has $40 of partnership basis.

If the property is sold for $120, the first $60 of gain must be allocated to Brian and the remaining $20 of gain will be divided equally between the two partners. The $60 of §704(c) built-in gain ($100 FMV at time of contribution – $40 adjusted basis) increases Brian's basis but it does not increase his capital account, however. Following the sale, each partner will have a capital account of $110 ($100 beginning capital account + $10 allocated gain) and each will have a partnership basis of $110. A liquidating distribution of $110 to each will be nontaxable.

Example 4. Use the same facts as **Example 3,** except the special allocation requirement of §704(c) is ignored and the entire $80 of gain is divided equally between the two partners. Accordingly, Ava and Brian each report $40 of the gain. Ava has a capital account of $140 and a basis of $140, and Brian has a capital account of $140 and basis of $80 ($40 beginning basis + $40 allocated gain). If the partnership is then liquidated and the $220 of assets is divided equally between the two, each will receive $110. Ava will then have a $30 capital loss ($110 distribution – $140 basis) and Brian will have a $30 capital gain ($110 distribution – $80 basis). The sum of the gain and the loss (treating it as positive) effectively represents the $60 built-in gain.

The result of failing to maintain capital accounts as well as tax basis accounts can therefore be that one partner is able to defer taxation while another partner pays unnecessary tax. Furthermore, it can have the effect of converting tax on ordinary income into a capital loss. This would have been the case if gain on the property contributed by Brian in the preceding example had been ordinary income property.

LIABILITIES

Liabilities play an important role in the taxation of partnerships and partners. As discussed in the following section, they are included in determining partners' outside bases in their partnership interests and, in the case of nonrecourse debt, they affect allocations. Each partner's share of liabilities is reported on the partner's Schedule K-1 in part II, item K. Practitioners must therefore be familiar with the rules for allocating liabilities in order to prepare Schedule K-1 correctly.

Partnership and partner liabilities are governed by IRC §752. For purposes of determining partners' outside bases, a partner's assumption of partnership debt is treated as a cash contribution. This is because entity-level debt of general partnerships is, under both state law and federal income tax law, nothing more than the collective individual debts of all the partners. An individual who purchases an asset with borrowed money is entitled to immediate basis rather than acquiring basis only as the liability is paid off. The only difference between an individual's debt and a partnership's debt is the collective nature of partnership debt.

The individual partners in a general partnership each have direct liability within the partnership for their proportionate shares of the partnership's borrowing. Thus, **partners can increase their outside bases in the partnership for their proportionate shares of the partnership's liabilities as if they had used the debt to purchase that portion of their partnership interest.** This manner of treating partners as simply a collection of individuals is an application of the **aggregate** theory of partnership taxation (as opposed to the **entity** approach, which treats the partnership as a separate entity).[74]

> **Example 5.** Alan and Brandy are each 50% members of AB, LLC, and share all allocations equally. Each has $50 of basis in their membership interest.
>
> The LLC borrows $200 and constructs a building with it. The partnership's inside basis in its assets increases by $200. Similarly, Alan and Brandy are each allocated $100 of the increase in liabilities. Each has an increase of $100 in their basis in the LLC without regard to whether they each have personally guaranteed the LLC's loan.

Debt relief is generally treated as the receipt of cash for income tax purposes. For partnership purposes, **the partner is treated as receiving a cash distribution** to the extent the partner is relieved of or has a decrease in the partner's share of partnership debt. If this constructive distribution is in excess of the partner's outside basis in the partnership, the excess is taxable as a sale or exchange of the partnership interest[75] resulting in long- or short-term capital gain based on the partner's holding period in the interest.[76]

Although debt of an LLC is more like corporate debt than partnership debt, the partnership rules are still applicable. The members are therefore able to use the basis resulting from the LLC's debt for purposes of deducting pass-through losses from the LLC and receiving nontaxable distributions from the LLC. As discussed later, however, if the partnership is formed as an LLC (or other limited liability partnership form), complications may arise based on differences between allocation of recourse debt and nonrecourse debt.

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74. See. e.g., *Holiday Village Shopping Center, Inc. v. U.S.,* 773 F.2d 276 (Fed. Cir. 1985).

75. IRC §731(a).

76. Treas. Reg. §1.1223-3.

DEFINITION OF LIABILITY

A **partnership liability** is an obligation that:[77]

- Creates or increases the basis of any of the partnership's assets, including cash;
- Gives rise to an immediate deduction to the partnership; or,
- Gives rise to an expense that is not deductible in computing the partnership's taxable income and is not properly chargeable to capital.

An **obligation** is more broadly defined than a liability. Obligations may include, but are not limited to, debt obligations, environmental obligations, tort obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments, such as options, forward contracts, and futures contracts.[78] Thus, a partnership may have an obligation, but it may not currently give rise to the existence of a liability for basis purposes.

Example 6. An accrual basis LLC is subject to a products liability suit. The suit results in a structured settlement under which the LLC will pay out damages to the plaintiff over a period of 10 years. Although the LLC has incurred an obligation, the obligation is not a liability.

In the preceding example, the obligation has not created or increased the basis of any of the LLC's assets and has not given rise to an expense that is not deductible in computing its taxable income or which is not properly chargeable to capital.[79] Finally, although the LLC is an accrual basis taxpayer and the all-events test[80] has been satisfied, the obligation does not give rise to an immediate deduction because of the economic performance limitation of IRC §461(h), which permits the LLC to take deductions in such cases only as payments are actually made to the plaintiff.

Partnership liabilities also do not include accrued but unpaid expenses or accounts payable of a cash basis partnership except to the extent of basis created in the assets.[81] The term "assets" includes capitalized items allocable to future periods[82] (e.g., organizational and start-up expenses) because such items have amortizable bases.

Applying the principles discussed above, a partner's share of liabilities, and therefore the **partner's outside basis,** can change as a result of any of the following.

- Contributions or distributions of debt-encumbered property to or from the partnership that increase or decrease the partnership's liabilities

  Example 7. Donald contributes property to ABC Partnership in exchange for a one-fourth partnership interest. The property has an FMV of $120, an adjusted basis of $60, and is subject to $80 of liabilities, which the partnership agrees to assume. The partnership has no other liabilities.

  The one-fourth partnership interest received by Donald has an initial basis of $60, Donald's basis in the contributed property. The $80 of liabilities assumed by the partnership is treated as cash distributed to Donald with respect to Donald's partnership interest. Finally, Donald is treated as having assumed one-fourth of the $80 of partnership liabilities, or $20. This assumption of $20 of partnership liabilities is treated as an additional cash contribution by Donald. The net effect of all these transactions is that Donald recognizes no income as a result of the transfer of the encumbered property, but he has a partnership basis of zero ($60 basis in property – $80 liabilities assumed by the partnership + $20 liabilities assumed by Donald = $0).

  The remaining partners of the partnership are treated as having contributed a total of $60 of cash to the partnership for their assumption of $60 of the liabilities and receive corresponding increases in bases.

77. Treas. Reg. §1.752-1(a)(4)(i).
78. Treas. Reg. §1.752-1(a)(4)(ii).
79. Treas. Reg. §1.752-1(a)(4)(i).
80. See Treas. Reg. §1.446-1(c)(1)(ii).
81. HR Rep. No. 98-861 (Conf. Rep.), 1984-3 CB 2 at 110-111.
82. IRS Pub. 541, *Partnerships*.

Example 8. Use the same facts as **Example 7,** except that Donald has only $40 of basis in the contributed property. Donald is now treated as having received a cash distribution in excess of basis of $20 and is required to recognize gain. This is because Donald has $20 of net liability relief in excess of basis ($40 basis in property – $80 liabilities assumed by partnership + $20 of liabilities assumed by Donald = ($20)). Because partners cannot have a negative partnership basis, any cash distribution in excess of basis is taxable as a sale of the partnership interest. The consequences to the other partners remain the same.

- Admission of a new partner or termination of a partner's interest that results in a decrease or increase in the partners' shares of partnership liabilities

  Example 9. ABC, LLC, has $36 of existing liabilities when Donyetta is brought into the LLC as a new, one-fourth member. The other members have personally guaranteed the debt and Donyetta is also required by the LLC's lender to execute a personal guarantee. Donyetta is therefore treated as having made a $9 cash contribution for the one-fourth of the liability assumed and receives a basis increase of $9. Each of the other members also holds a one-fourth interest, and each is treated as having received a $3 cash distribution for their share of the $9 of liability assumed by Donyetta.

- The partnership incurs a new liability or pays off an existing liability resulting in an increase or decrease in partnership liabilities
- Cancellation of debt resulting in a decrease in partnership liabilities

Partners are entitled to take into account in their outside bases their shares of both recourse and nonrecourse partnership debt.[83] **Recourse debt** means simply that individual partners have personal liability for repayment to the creditor if the partnership is unable to repay the debt.[84] **Nonrecourse debt** means the individual partners have no personal legal obligation to the creditor.[85] The only action the creditor can take with respect to nonrecourse debt is to foreclose upon the property that secures the debt. If the value of the property is not sufficient to pay off the debt, the lender loses.

Thus, with recourse debt, the partners bear the ultimate economic risk of loss. With nonrecourse debt, the lender bears the ultimate risk of loss. However, partners are permitted to increase their outside bases for both types of debt.[86] It is therefore necessary to distinguish between recourse and nonrecourse debt because different rules are used to determine how the two different types of debt are allocated among the partners.

RECOURSE LIABILITIES

A partner's share of a partnership's recourse liabilities is that portion of a liability for which the partner or a related person bears the economic risk of loss. Whether there is an economic risk of loss is determined under a constructive liquidation test.[87] This is a worst-case scenario that determines how much the partner would be obligated to pay to any creditor of the partnership or contribute to the partnership because a liability becomes due and payable and the partner who has to make payment is not entitled to reimbursement from anyone else.

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83. Treas. Regs. §§1.752-2 and 1.752-3.
84. Treas. Reg. §1.752-1(a)(1).
85. Treas. Reg. §1.752-1(a)(2).
86. Treas. Regs. §§1.752-2 and 1.752-3.
87. Treas. Reg. §1.752-2(b)(1).

Under the **constructive liquidation** approach, all of the following events are deemed to occur simultaneously.[88]

- All of the partnership's liabilities become payable in full.
- With the exception of property contributed to secure a partnership liability,[89] all of the partnership's assets, including cash, have a value of zero.
- The partnership disposes of all of its property in a fully taxable transaction for no consideration except relief from nonrecourse liabilities in which the creditor's right to reimbursement is limited solely to partnership assets.
- All items of income, gain, loss, or deduction are allocated among the partners.
- The partnership liquidates.

After all these events, it is necessary to determine which partners are liable for repayment and for how much. That is the extent to which each partner bears the economic risk of loss and is therefore the extent to which each partner is allocated recourse debt of the partnership.

The regulations contain a number of rules that must be applied in determining a partner's share of **recourse debt.** Following is a summary of those rules.[90]

- Contingent obligations are ignored if the obligation is subject to contingencies that make it unlikely that the obligation will ever be paid. If the obligation will arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.
- It is assumed that all partners who have obligations to make payments actually perform those obligations irrespective of their actual net worth.
- A partner bears the economic risk of loss for a partnership liability to the extent the partner makes a nonrecourse loan to the partnership and no risk of loss for the liability is borne by any other partner. This rule does not apply in the case of a qualified nonrecourse loan to a partnership by a partner whose interest in all partnership items is 10% or less.
- If a partnership liability is owed to a partner but that liability is wrapped around (i.e., includes) a nonrecourse liability that encumbers partnership property and which is owed to a third party, the partnership liability is treated as two separate liabilities. The portion of the partnership liability relating to the wrapped debt is treated as owed to the third party, and the rest is owed to the partner.
- If payment by a partner is not required before the later of the end of the year in which the partner's interest is liquidated or 90 days after the liquidation, the obligation to make payment is recognized only to the extent of the present value of the obligation unless it bears interest at least equal to the applicable federal rate (AFR).
- A partner's promissory note does not satisfy a partnership obligation unless the note is readily tradeable on an established securities market.
- A partner bears the risk of loss for a partnership liability to the extent of the FMV of any of the partner's separate property (other than an interest in the partnership) that is pledged as security for the partnership liability.
- A partner bears the risk of loss for a partnership liability to the extent of the FMV of any property the partner contributes to the partnership solely for the purpose of securing a partnership liability. All tax items attributable to the property must be allocated to the contributing partner, however, and this allocation must generally be greater than the partner's share of other significant partnership items.

88. Ibid.

89. The contributing partners are treated as bearing the economic risk of loss of the property if the requirements of Treas. Reg. §1.752-2(h)(2) are satisfied.

90. Treas. Reg. §1.752-2.

Example 10. Alphonso and Brady form a general partnership, with each contributing $10,000 in cash. The partnership purchases an office building on leased land for $100,000 from an unrelated seller for which it pays $20,000 in cash and executes a note to the seller for the balance of $80,000. The note is a general obligation of the partnership (i.e., no partner has been relieved from personal liability). The partnership agreement provides that all items are allocated equally except that tax losses are specially allocated 90% to Alphonso and 10% to Brady and that capital accounts will be maintained in accordance with the regulations under IRC §704(b) (discussed later), including a deficit restoration obligation (DRO) on liquidation (discussed later).

In a constructive liquidation, the $80,000 liability becomes due and payable. All of the partnership's assets, including the building, are deemed worthless. The building is deemed sold for a value of zero. Capital accounts are adjusted to reflect the loss on the disposition, as follows.

	Alphonso	Brady
Initial contribution	$10,000	$10,000
Loss on sale	(90,000)	(10,000)
Capital account	($80,000)	$ 0

Other than the partners' obligation to fund negative capital accounts on liquidation, there are no other contractual or statutory payment obligations existing between the partners, the partnership, and the lender. Therefore, the $80,000 partnership liability is classified as a recourse liability because one or more partners bear the economic risk of loss for nonpayment. Brady has no share of the liability because the constructive liquidation produces no payment obligations for Brady. Alphonso's share of the partnership liability is $80,000 because he would have an obligation in that amount to make a contribution to the partnership.

NONRECOURSE LIABILITIES

If a partnership has nonrecourse liabilities, allocations to partners of tax items based on those liabilities cannot have economic effect. This is because, with nonrecourse liabilities, it is the creditor who bears the economic risk of loss, not the partners. With nonrecourse liabilities, the creditor's only remedy is against assets that secure the liability. To the extent the value of assets is not sufficient to satisfy the liability, the creditor has no recourse against the partners and therefore is the one who suffers the economic loss.[91]

Notwithstanding their lack of economic risk, partners have traditionally been permitted to use nonrecourse liabilities in determining basis for allocations and distributions. The regulations contain the following rules for allocations based on nonrecourse liabilities which, if they are satisfied, result in those allocations being deemed in accordance with the partners' interests in the partnership.[92]

1. Throughout the full term of the partnership, capital accounts are maintained in accordance with Treas. Reg. §1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances. Partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset.

2. Beginning in the first tax year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities (e.g., depreciation of the asset securing the nonrecourse debt).

91. Treas. Reg. §1.704-2(b)(1).

92. Treas. Reg. §§1.704-2(e)(1)–(4).

3. Beginning in the first tax year of the partnership in which it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of the regulations (described later).

4. All other material **allocations** and capital account adjustments under the partnership agreement are recognized under Treas. Reg. §1.704-1(b).

Although the regulations under IRC §752 briefly address the allocation of **nonrecourse liabilities,**[93] the substantive application of those regulations is found under the allocation regulations of IRC §§704(b) and (c). The regulations provide that a partner's allocation of a deduction generated from nonrecourse liabilities must be matched by an allocation of the nonrecourse liability in order to permit the partner to take the deduction. For example, a partner who is allocated a $100 loss attributable to property subject to a nonrecourse liability is also allocated a $100 share of the nonrecourse debt. The allocation of the $100 liability to the partner is a basis increase in the partner's partnership interest, which then permits the $100 loss to be deducted.[94]

A partner's share of the **nonrecourse liabilities** of a partnership is the sum of the following.[95]

1. The partner's share of **partnership minimum gain** determined in accordance with the rules of IRC §704(b) and the regulations thereunder

2. The amount of any taxable gain that would be allocated to the partner under §704(c) (built-in-gain on contribution of an asset to the partnership or revaluation of partnership property) if the partnership disposed of all its properties (in a taxable transaction) subject to nonrecourse liabilities in full satisfaction of the liabilities and for no other consideration

3. The partner's share of all other nonrecourse liabilities not otherwise allocated under the first two steps, allocated in accordance with the partner's share of partnership profits (See Treas. Reg. §1.752-3(a)(3) for further information on these allocations.)

The reason for the first two allocations from the preceding list is that these are income items that **must** be allocated to a particular partner. As will become evident from the discussion of minimum gain and minimum gain chargeback in connection with allocations, partners who are allocated basis from nonrecourse partnership liabilities and who take deductions against that basis are always required to pay those deductions back if the property securing the nonrecourse debt is disposed of.

> **Note.** The following is a simplified discussion of minimum gain and minimum gain chargeback, which is intended to explain basic concepts. Practitioners must consult Treas. Reg. §1.704-2 for detailed information.

93. Treas. Reg. §1.752-3.

94. Treas. Reg. §1.704-2.

95. Treas. Reg. §1.752-3(a).

Partnership Minimum Gain

Deductions based on **nonrecourse** liabilities are allocated among partners to the extent of **partnership minimum gain.**[96] Partnership minimum gain represents the minimum taxable gain a partnership would have if it disposed of property subject to nonrecourse liabilities solely in satisfaction of those liabilities.[97] For this purpose, the minimum gain of each property subject to a nonrecourse liability is determined separately, then totaled.[98] Any property for which a disposition would result in a loss (because the associated nonrecourse liability is less than the adjusted basis) is ignored and does not reduce partnership minimum gain because only gains are taken into account.[99] Partnership minimum gain must be calculated annually and will increase or decrease each year in which the difference between nonrecourse debt and the basis of the property securing the debt fluctuates due to such things as payments on principal or depreciation.[100]

Example 11. An LLC has three properties that secure nonrecourse liabilities. The partnership minimum gain is calculated as follows.

	Nonrecourse Liability	Basis	Minimum Gain
Property 1	$100	$80	$20
Property 2	60	50	10
Property 3	40	50	0
Partnership minimum gain			$30

Nonrecourse deductions can be allocated among the partners to the extent of $30.

Nonrecourse deductions for a year equal the net increase in partnership minimum gain for the year reduced, but not below zero, by aggregate distributions made during the year of proceeds of nonrecourse borrowing that are treated as distributions of partnership minimum gain.[101] Once the amount of nonrecourse deductions is determined, they are allocated as nonrecourse deductions in accordance with ordering rules found at Treas. Reg. §1.704-2(j) (not covered in these materials).

Minimum Gain Chargeback. The purpose of the partnership minimum gain provisions is to ensure that there are no unintended tax benefits from permitting partners to take **nonrecourse** deductions based on minimum gain. This is true because any taxable disposition of property securing nonrecourse debt results in a sale for income tax purposes for an amount realized that is at least equal to the nonrecourse debt regardless of the FMV of the property.[102]

Example 12. Use the same facts at **Example 11.** Property 1 has an FMV of $90 and the creditor forecloses on the property. The partnership is taxed as if it sold the property for the amount of the nonrecourse debt, $100, and not its $90 FMV. The partnership is therefore required to recognize $20 of gain.

Furthermore, any decrease in the partnership minimum gain from the previous year's minimum gain requires repayment of prior nonrecourse deductions to the extent of the amount of the decrease. This is **minimum gain chargeback.**[103] These rules ensure that a partner who has been allocated nonrecourse deductions is also allocated a proportionate share of income and gain from property that secures the nonrecourse debt in any year that a net decrease in partnership minimum gain occurs.

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96. Treas. Reg. §1.704-2(c).

97. Treas. Reg. §1.704-2(d)(1).

98. See, e.g., Treas. Reg. §1.704-2(m), Example 2.

99. Treas. Reg. §1.704-2(d)(1).

100. Ibid.

101. Treas. Reg. §1.704-2(c).

102. *Tufts v Comm'r,* 461 U.S. 300 (1983).

103. Treas. Reg. §1.704-2(b)(2).

Example 13. Use the same facts as **Example 12.** There was a $20 decrease in the partnership minimum gain because of the foreclosure on Property 1. The partners to whom nonrecourse deductions were allocated based on the $20 of minimum gain of Property 1 must "pay back" those deductions based on their share of the net decrease in partnership minimum gain.

Minimum gain chargeback is accomplished by allocating income to partners subject to the chargeback. Under the ordering rules, this consists first of gains recognized from the disposition of property securing nonrecourse liabilities or discharge of indebtedness relating to nonrecourse liabilities and then, if necessary, from a pro rata share of all the partnership's other items of income and gain for that year. If the amount of chargeback exceeds the total partnership income for the year, the excess chargeback carries over to the next year.[104] The allocation of gain and income required for a minimum gain chargeback is made before any other allocation of partnership items.[105]

Practical Impact. It is common for **boilerplate** partnership and operating agreements to contain the necessary minimum gain provisions to comply with the regulations. Realistically, however, one must consider the extent to which the minimum gain rules are even applicable to a typical operating LLC (or other partnership form) that is not engaged in a traditional nonrecourse real estate lending activity.

First, **debt guaranteed** by any partner of the partnership or for which any partner otherwise incurs liability is not nonrecourse debt. Instead, the debt is recourse with respect to the partner or partners who have personal liability for it if the partnership fails to pay the debt.

Second, if allocations of profits and losses are consistent with each partner's interest in the partnership and there are no special allocations of deductions (other than mandated allocations such as under IRC §704(c)), there is no difference between allocations based on nonrecourse debt and allocations based on recourse debt. All partners will always be allocated offsetting income items in proportion to prior losses.

Effect of LLC on Allocation of Liabilities

An LLC, like a corporation, is an entity separate from its members for liability purposes. Thus, if an LLC borrows money, the members who own the LLC have no liability for the debt except to the extent they personally guarantee it. If, however, property that is subject to an existing liability is transferred to an LLC, those persons who borrowed the money remain fully liable **under state law**[106] for repayment of the debt, even though the LLC agrees to assume the debt unless the lender agrees otherwise. In fact, states with statutes permitting direct conversions from a partnership to an LLC provide that, if a partnership converts to an LLC, both the LLC and the partners of the former partnership remain fully liable for all the partnership's debts.[107]

If the LLC does agree to assume a liability, the rules concerning transfers of encumbered property in exchange for partnership interests apply. Here, however, there may be a significant difference. Unless the creditor releases the contributing member from the obligation, the contributing member remains fully liable for repayment of the debt assumed by the LLC. The LLC also is liable for repayment. The other members of the LLC, however, have no personal liability for repayment of the debt unless they give personal guarantees to the lender. This means the debt is nonrecourse for those other members but fully recourse for the contributing member, who then is allocated the entire liability basis as partner recourse debt. This is **partner nonrecourse debt.**[108] If the lender agreed to release a contributing member from liability and to look only to the LLC for repayment, the debt would be treated as nonrecourse with respect to all members.

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104. Treas. Reg. §1.704-2(f)(6).

105. Treas. Reg. §1.704-2(j).

106. See, e.g., §347.125.4, Revised Statutes of Missouri.

107. Ibid.

108. Treas. Reg. §1.704-2(b)(4).

Example 14. Delta contributes encumbered property to an LLC in exchange for a one-fourth membership interest. The property has an FMV of $120, an adjusted basis of $60, and is subject to $80 of liabilities. The LLC agrees to assume the debt, but none of the other members execute personal guarantees. The lender does not agree to release Delta from liability.

Because Delta remains liable for repayment of the entire $80 debt, it is treated as recourse with respect to her and as nonrecourse with respect to the remaining members. Thus, the entire liability is allocated to Delta under the partnership rules. As a result, Delta is not treated as receiving a constructive distribution of cash because of the assumption of the obligation by the LLC. She receives no outside basis attributable to the assumption of any portion of the $80 liability, and she has a basis in the outside interest of $60, the adjusted basis of the contributed property.

If this were a general partnership instead of an LLC or the other members personally guaranteed the debt, it would be recourse to all of them. Delta would therefore have $80 of liability relief from the assumption of the debt that is treated as a cash distribution, but she would also take a $20 share of the liability that is treated as a cash contribution. Delta would have a net cash distribution of $60 from liability relief that is nontaxable. This would reduce Delta's basis from $60 to zero. The remaining partners are each allocated $20 of the assumed liability, which is treated as cash contributions. These partners' bases increase by the same amount.[109]

IRC §754 ELECTION

Note. The following is a brief description of basis adjustment elections under §754. The manner in which basis allocations must be made can be complex and is beyond the scope of these materials. Practitioners making §754 elections must consult the appropriate regulations.[110]

WITHOUT §754 ELECTION

Inside and outside bases can become unequal when events such as the following occur.

- A taxpayer buys a partnership interest for an amount that differs from the selling partner's basis in the interest.
- A partner dies and the IRC §1014 FMV basis is different from the deceased partner's partnership basis.
- A partnership distributes cash or property with a basis in excess of the recipient partner's basis in the partnership interest.

If there is a change to an individual partner's outside basis through purchase or inheritance, there is no effect on the partnership's inside basis in its assets. The effect is therefore to delay the acquiring partner's ability to recover the higher outside basis until termination of the partnership interest or of the partnership.

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109. Treas. Reg. §1.722-1.

110. Treas. Reg. §§1.734-1 and 1.734-2 (adjustments to partnership's inside basis based on distributions to partners); Treas. Reg. §1.743-1 (adjustments to partner's outside basis and share of partnership's inside basis); Treas. Reg. §1.755-1 (allocation of bases among partnership assets for adjustments under IRC §§734 and 743).

Example 15. Derek and Erin own a 40% and 60% interest in partnership DE, respectively, with an FMV of $100 and an adjusted basis of $50. Derek sells his interest to Farrell for $100. The partnership has a depreciable asset with an FMV of $200 and an adjusted basis of $100, of which Derek's share of inside basis is $40.

After the sale, Farrell has a partnership interest with an outside basis of $100 based on the purchase price. Under the entity approach, however, Farrell continues to have the same $40 inside basis share that Derek had.

After the partnership fully depreciates the asset, Farrell's outside basis is reduced from $100 to $60 and Erin's outside basis is reduced from $60 to $0.

If the asset is then sold for $200, the gain is $200, which is divided 60/40 between Erin and Farrell, leaving Farrell with an outside partnership basis of $140 and Erin with a partnership basis of $120. If the $200 cash is then distributed 60/40 between the two partners in liquidation of the partnership, Erin receives the $120 tax-free and her basis is reduced to zero. Farrell receives the $80 tax-free but his basis is reduced to $60, leaving him with a $60 capital loss ($80 – $140 basis).

WITH §754 ELECTION

Differences between inside and outside bases can be eliminated if the partnership made or makes an election under IRC §754 for the tax year in which the difference arises. This election permits the inside bases of partnership assets to be adjusted in accordance with the following Code sections.

- IRC §743(b) and its regulations[111] for transfers of partnership interests
- IRC §734(b) and its regulations[112] for distributions in a manner that restores equality between inside and outside basis

In addition, guidance is provided under the following Code sections.

- IRC §755 and its regulations[113] provide the actual manner in which allocations are made.
- IRC §754 and its regulations[114] provide the manner in which the election is made (see the "Making the Election" section later).

Partner Adjustments Under IRC §743(b)

Under §743, the partnership adjusts its basis of inside assets to reflect the outside increase or decrease of basis for a transfer of a partnership interest. The total amount of adjustment is the difference between the acquiring partner's basis in the partnership interest and that partner's share of the partnership's basis for its assets, including liabilities but excluding cash.

Example 16. Use the same facts as **Example 15,** except the DE partnership made a §754 election. Farrell can increase the inside basis he has in the asset by $60, the excess of his outside basis ($100) over his share of the partnership's inside basis ($40).

Farrell now has a $100 inside basis in the partnership asset to equal his $100 outside basis. When the asset with an adjusted basis of $100 is fully depreciated, Erin will have taken $60 of depreciation and reduced her outside basis to zero. Farrell will have taken $100 of depreciation because depreciation on the $60 increase in basis he receives under §743 will be specially allocated to him. His basis will therefore also be zero.

If the asset is sold for $200, the partnership will have $200 of gain ($200 amount realized – $0 adjusted basis). Farrell will be allocated $80 of the gain and Erin will be allocated $120 of the gain. Erin's outside basis will increase by her $120 of gain and Farrell's basis will increase by his $80 of gain. A distribution to each of their shares of the proceeds will be nontaxable.

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111. Treas. Reg. §1.743-1.

112. Treas. Regs. §§1.734-1 and 1.734-2.

113. Treas. Reg. §1.755-1.

114. Treas. Reg. §1.754-1.

The special adjustment under IRC §743(b) can only be used by the acquiring partner. Furthermore, the partnership must now keep two sets of books, one for the acquiring partner and one for the remaining partners. Partnership items adjusted under IRC §743(b) are specially allocated to the acquiring partner. **Adjustments may be either positive or negative.** Negative adjustments do not affect the other partners under IRC §743, but they do under IRC §734 (as explained in the next section). Thus, a partnership may be somewhat reluctant to make an IRC §754 election because of the possibility of future adverse adjustments.

Under IRC §755, the IRC §743(b) special adjustment is made only among assets that were owned by the partnership at the time of acquisition. The bases of assets acquired later are generally not affected unless there is insufficient property or adjusted basis for such property, in which case an IRC §734(b) adjustment (discussed in the next section) is applied to subsequently acquired property of a like character.[115] The assets are required to be divided into two classes — ordinary income assets and capital gain assets. Because the IRC §743(b) special adjustment can only be used to reduce the difference between the basis of an asset and its FMV, it is next necessary to determine the net appreciation or depreciation in value of each class (total FMV of the class less total adjusted basis).

Allocations are also required to be made to IRC §197 intangibles (such as goodwill) using the principles of IRC §1060 that apply in the case of applicable asset acquisitions (not covered in this chapter).[116]

To the extent a positive IRC §743(b) adjustment is made to a depreciable asset, it is treated as a separate asset placed in service in the year of adjustment for depreciation purposes.[117] This is not true for purposes of expensing under §179 because that election must be made at the partnership level and the adjustment to the basis of partnership property under §743 has no effect on the partnership's computation of any item of partnership income or deduction.[118] A negative adjustment reduces subsequent depreciation deductions.[119] Adjustments are also taken into account for purposes of subsequent sales and distributions by the partnership, including the "collapsible" provisions of IRC §751.[120] The special allocation is personal to the acquiring partner and cannot be transferred to any other partner.[121] However, if property in which there is a special basis adjustment is distributed to a different partner, the adjustment is reallocated to another like-kind partnership asset.[122]

> **Observation.** The amount of the §743(b) adjustment to a depreciable asset is not eligible for the §179 deduction because the adjustment is merely a recharacterization of the partnership interest under the §754 election.

115. Treas. Reg. §1.755-1(c)(4).
116. Treas. Reg. §1.755-1(a)(2).
117. Treas. Reg. §1.743-1(j)(4)(i).
118. Treas. Reg. §1.743-1(j)(1).
119. Treas. Reg. §1.743-1(j)(4)(ii).
120. Treas. Reg. §1.751-1(c)(6).
121. Treas. Reg. §1.743-1(g)(2)(i).
122. Treas. Reg. §1.743-1(g)(2)(ii).

Partnership Adjustments Under IRC §734

IRC §734 special basis adjustments prevent distortions from occurring inside the partnership with respect to other partners because of gain or loss reported by a partner receiving a distribution or in the event that a partner's basis in an asset differs from the partnership's basis in that asset.

Example 17. Alice, Brandon, and Charlotte are equal partners in a partnership. The partnership's basis and book values and the partners' bases and FMVs are as follows.

Partnership's Assets	Basis	Book
Cash	$2,000	$2,000
Capital asset	1,000	1,000
Total	$3,000	$3,000

Partners' Interests	Basis	FMV
Alice	$1,000	$2,000
Brandon	1,000	2,000
Charlotte	1,000	2,000
Total	$3,000	$6,000

The capital asset has an FMV of $4,000. Alice receives a liquidating distribution of $2,000 in cash and therefore recognizes $1,000 of gain ($2,000 cash – $1,000 basis). With no §754 election in effect, the partnership's basis and book values and the partners' bases and FMVs following the distribution are as follows.

Partnership's Assets	Basis	Book
Cash	$ 0	$ 0
Capital asset	1,000	1,000
Total	$1,000	$1,000

Partners' Interests	Basis	FMV
Brandon	$1,000	$2,000
Charlotte	1,000	2,000
Total	$2,000	$4,000

If the partnership sells the capital asset for its $4,000 value, the partnership has a $3,000 gain, which is split between Brandon and Charlotte, the remaining partners. Thus, Alice, Brandon, and Charlotte will have reported $4,000 in gains, when there was only $3,000 of appreciation in the partnership assets.

However, Brandon and Charlotte each receive increases in their bases of $1,500 for the gain they reported. Thus, they each have $2,500 of basis following the sale of the asset.

A liquidating distribution of $2,000 to each of them is received tax-free and results in a $500 capital loss to each ($2,000 distribution – $2,500 basis) but only **after** the liquidating distribution is made. Thus, the net taxable amount for all three partners is only $3,000 but the lack of an IRC §754 election results in a distortion. With an IRC §754 election in effect, under IRC §734 the partnership's basis in the asset would be increased by the $1,000 of gain recognized by Alice, resulting in only $2,000 of gain on the sale of the asset. Therefore, the distortion is avoided.

If an IRC §754 election is in effect, IRC §734 uses the amount of gain or loss to the distributee partner and the basis differential between the partnership's basis and the distributee's basis to make the adjustment to the bases of inside assets to prevent the distortion. Assets are divided into capital gain and ordinary income groups, as is the case with IRC §743 adjustments. If the adjustment is a result of the recognition of gain or loss by the distributee, it is applied only to the capital gain group. If it is a result of a basis differential, it is applied to partnership assets of the same category that the distributed property belonged to.

Once it is determined which group the adjustment applies to, the same allocation rules apply as for IRC §743 regarding which appreciated or depreciated assets the adjustments are actually applied to. If there are no assets in a group, the adjustment is held in abeyance until it can be applied.

Special basis increases can be allocated to a class only if the class has appreciated in value; decreases can be allocated only if a class has depreciated in value. If both classes are the same, the increase or decrease is allocated between them based on the relative appreciation or depreciation of each class. Allocations to specific assets within each group follow the same rules.[123]

Making the Election

The partnership **must elect** under IRC §754 to have the special basis allocation rules of IRC §§734 and 743 apply for the year in which a qualifying distribution or transfer occurs.[124] It is not necessary to make the election the first year this happens. However, if the election is made, it is irrevocable without the IRS's consent.

Once the election is made, it applies to the partnership with respect to distributions of properties to partners under IRC §734 and to partners who acquire their interests through transfers by sale, exchange, or death under IRC §743. The actual method of allocation is set forth at IRC §755. This is a partnership election and, if the partnership refuses to make it, an individual partner cannot adjust their inside basis.

In the event a partnership fails to make a timely election, IRS regulations provide an automatic extension of 12 months to make the election.[125] If the partnership **does not extend** its return, the 12-month period is measured from the **unextended** due date of the partnership return for the year for which the election should have been made. If the partnership **extends** its return, the 12-month period is measured from the **extended** due date. The regulations provide the manner in which the extended election must be made.

ALLOCATIONS

The general rule of partnership taxation under subchapter K is that a partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement.[126] Partners are usually able to allocate these items under the partnership agreement in any manner they choose unless allocations lack substantial economic effect.[127] The most basic form of allocation is simply to allocate all items among the partners in proportion to their partnership ownership interest.

Whenever allocations depart from this standard, they are generally referred to as **special allocations.** The classic example of special allocations is to allocate initial limited partnership losses to the limited partners. The fact that there is a special allocation does not necessarily mean it is abusive, however. The attractive feature of special allocations is that they give the partners the ability to change various aspects of allocations in order to more accurately reflect the economic relationship they have or to enhance that relationship through the addition of tax benefits.

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123. Treas. Reg. §1.755-1(c)(2).

124. Treas. Reg. §1.754-1(b)(1).

125. Treas. Reg. §1.9100-2.

126. IRC §704(a).

127. IRC §704(b)(2).

The downside of special allocations is that they significantly increase the complexity of partnership tax rules. The IRS published extensive regulations under IRC §704 intended to permit partnerships to make special allocations while simultaneously attempting to control the potential for abuse. These regulations are some of the most complex provisions of partnership tax under subchapter K.

SUBSTANTIAL ECONOMIC EFFECT REQUIREMENT

A special allocation is an allocation of a partnership item that is disproportionate to the partners' capital contributions or to their ratio for sharing other partnership items. For special allocations to be respected, the regulations require that they have **substantial economic effect.**[128] This means the income tax consequences of an allocation must be assigned to the partner who receives the benefit or bears the burden of the economic consequences.[129] For example, a partner who is allocated a disproportionately large share of depreciation must also be assigned the same disproportionately large reduction in the economic value of the partner's partnership interest. Thus, tax allocations **must be matched** by economic allocations.

If an allocation is found not to have substantial economic effect, the offending allocation is required to be reallocated among the partners in proportion to their **interests in the partnership.**[130] This is based on the manner in which the partners have agreed to share the economic benefit (income) or burden (deduction), if any, corresponding to the item that is specially allocated. It is a facts-and-circumstances determination, with no set rules. In determining a partner's interest in the partnership, the regulations list the following factors as being among those that are considered.[131]

- The partner's relative contributions to the partnership
- The interests of the partners in economic profits and losses if different from their interests in taxable income or loss
- The interests of the partners in cash flow and other nonliquidating distributions
- The rights of the partners to distributions of capital upon liquidation

The determination of whether an allocation has substantial economic effect involves a 2-part analysis that is made at the end of the partnership tax year to which the allocation relates.[132]

1. The allocation must have **economic effect.**
2. The economic effect of the allocation must be **substantial.**

Economic Effect

In order to ensure allocations have the necessary economic effect, the regulations require that, throughout the full term of the partnership, the partnership agreement contain the following provisions.[133]

- The partners' capital accounts are determined and maintained throughout the full term of the partnership in accordance with the capital (book) accounting rules of Treas. Reg. §1.704-1(b)(2)(iv).
- Liquidation proceeds are required (after certain capital account adjustments) to be distributed only in accordance with positive capital account balances by the later of the end of the tax year or 90 days after the date of liquidation.
- There is a **deficit restoration obligation** (**DRO**) in the partnership agreement or under applicable state law. This is an unconditional obligation requiring a partner to restore to the partnership any negative balance in the partner's capital account by the later of the end of the tax year or 90 days after the date of liquidation. This can also be satisfied by the partner giving a promissory note to the partnership (discussed later).

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128. Treas. Reg. §1.704-1(b)(2)(i).
129. Treas. Reg. §1.704-1(b)(2)(ii)(a).
130. Treas. Reg. §1.704-1(b)(1)(i).
131. Treas. Reg. §1.704-1(b)(3)(ii).
132. Treas. Reg. §1.704-1(b)(2)(i).
133. Treas. Reg. §1.704-1(b)(2)(ii)(b).

Example 18. Satisfaction of Economic Effect Test. Giselle and Marcus form an LLC with cash contributions of $40,000 each. This is used to purchase depreciable property for $80,000. The operating agreement provides that the members share income and losses equally except that all depreciation deductions are allocated to Giselle. The operating agreement further complies with the economic effect requirements, including a DRO.

In the LLC's first tax year, income and expenses are equal, and there is a depreciation deduction of $20,000 allocated entirely to Giselle. The LLC liquidates at the end of its first tax year and distributes assets in proportion to the members' capital accounts.

	Giselle		Marcus	
	Basis	Book	Basis	Book
Initial capital account	$40,000	$40,000	$40,000	$40,000
Depreciation	(20,000)	(20,000)	0	0
Capital account end of Year 1	$20,000	$20,000	$40,000	$40,000

Upon liquidation of the LLC, Giselle is entitled to a distribution of only $20,000, reflecting the $20,000 of depreciation allocated to her. Marcus, who had no depreciation allocation and whose capital account remains unchanged, is entitled to a distribution of $40,000.

Although members of an LLC do not have a DRO under state law, the operating agreement in the preceding example is presumed to have one for purposes of simplicity. In fact, an LLC will probably use the alternate economic effect test (qualified income offset, which is discussed in the next section).

In the preceding example, the value of the asset is deemed to decline to the extent of the tax depreciation.[134] Furthermore, the capital accounting rules do not permit revaluation of the asset to determine its true market value on the presumed liquidation date.[135] This is in keeping with the requirement that value equals basis, which ensures that tax allocations have a dollar-for-dollar impact on a partner's economic investment in the partnership.

The following examples illustrate the effects of **a failure to comply** with the capital account distribution rules.

Example 19. Failure of Liquidating Test. Use the same facts as **Example 18,** except that, upon liquidation, distributions are made equally between Giselle and Marcus without regard to capital accounts. Each member is therefore entitled to a distribution of $30,000. This fails to satisfy the economic effect test because Marcus' cumulative economic investment in the LLC is $40,000, yet he receives only $30,000 in liquidation. Giselle, on the other hand, has a cumulative economic investment of only $20,000, but she receives a $30,000 distribution.

In effect, Marcus pays for half of the depreciation deduction without being allocated any of it. This fails the economic effect test, and the depreciation deduction must be reallocated in accordance with the members' equal interests in the LLC.

134. Treas. Reg. §1.704-1(b)(2)(iv)(g)(1).

135. Treas. Reg. §1.704-1(b)(2)(iv)(f).

Example 20. Failure of DRO. Mitch and Rita form an LLC with contributions of $75,000 and $25,000, respectively. The operating agreement divides all items of income and loss equally between the two members and otherwise satisfies the requirements of the regulations except that there is no DRO and the alternate test is not satisfied. Therefore, the agreement does not satisfy the economic effect test, and the allocations will not be respected.

The LLC has $20,000 of losses in each of its first three years. If the allocations in the operating agreement were honored and the partnership liquidated at the end of Year 3, the capital accounts would be as follows.

	Mitch		Rita	
	Basis	Book	Basis	Book
Initial capital account	$75,000	$75,000	$25,000	$25,000
Losses years 1, 2, 3	(30,000)	(30,000)	(30,000)	(30,000)
Capital account end of Year 3	$45,000	$45,000	($ 5,000)	($ 5,000)

The value of the LLC's assets were reduced from $100,000 to $40,000. In a liquidating distribution, Mitch should receive $45,000, but only receives $40,000. Thus, Mitch is suffering $5,000 of economic loss attributable to Rita's deficit capital account.

If the operating agreement contained a DRO (or satisfied the alternate test discussed later), the allocation would have been respected. With a DRO, Rita would be obligated to contribute $5,000 to the LLC to restore her deficit capital account to zero. The $5,000 would be distributable to Mitch, who would then have received the entire $45,000 to which he was entitled.

The economic effect test is satisfied to the extent a partner has a DRO. Alternatively, a partner may provide a **limited DRO,** which satisfies the economic effect test to that extent. This may be accomplished by including a provision for a limited DRO in the operating agreement.

If there is no express obligation for a DRO in the operating agreement, the partner can contribute a **promissory note** to the LLC. A promissory note constitutes a DRO to the extent of its outstanding principal balance as long as the partner is the maker of the note and meets the following requirements.[136]

1. The note is required to be satisfied no later than the end of the partnership year in which the partner's interest is liquidated or, if later, within 90 days after the date of such liquidation.
2. If the promissory note is negotiable, the partnership agreement can provide that satisfaction under the preceding paragraph is not required, but the partnership will retain the note. The partner must contribute the excess of the outstanding principal of the note over its FMV at the time of liquidation.

Example 21. Curative DRO. Use the same facts as **Example 20,** except Rita contributed a promissory note to the LLC with a face amount of $5,000. If the note satisfies the requirements of the regulations, Rita is treated as having a $5,000 limited DRO, and the allocation of the additional $5,000 loss to Mitch will be respected.

A partner is permitted to reduce or eliminate an existing DRO as long as the reduction or elimination operates only prospectively and does not affect a DRO the partner may have for an existing deficit capital account.[137]

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

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

A member's guarantee of an LLC's debt owed to a third party is not the same thing as a DRO. A DRO is essentially a debt owed to another partner in the partnership, not to third parties. The existence of guarantees by LLC members relates to whether the LLC's debt is classified as recourse or nonrecourse for purposes of allocating basis among partners (discussed previously in the "Liabilities" section).

Example 22. Guarantee of Third-Party Debt. Viola and Tom contribute $7,500 and $2,500, respectively, to an LLC taxed as a partnership. The LLC borrows $90,000, with each partner signing a full guarantee of the entire $90,000. Other income and expenses are equal and the depreciation deduction is in excess of those items. All tax items are divided between the partners based on their ownership percentages except depreciation, which is allocated equally between them. The operating agreement satisfies the requirements for the economic effect test except that there is no DRO (nor compliance with the alternate test).

Because of the guarantees, the $90,000 of debt is treated as recourse. Viola is allocated $67,500 (75%) of the debt and Tom is allocated $22,500 (25%), based on their ownership percentages.

The partnership buys a depreciable asset for $100,000. Each year, $10,000 of depreciation is allocated equally: $5,000 each to Viola and Tom. Based on this fact, the partnership agreement fails the economic effect test in the first year.

At the end of year 2, the partnership liquidates. No principal payments were made on the loan. The property is sold for $80,000, which is equal to its basis, and the proceeds of the sale are used for loan repayment. Under their guarantees, Viola pays $7,500 to the lender and Tom pays $2,500. This is treated as a constructive contribution to the partnership, increasing their bases by the same amount. The following accounting shows why the economic effect test is not satisfied.

	Viola		Tom	
	Basis	Book	Basis	Book
Initial capital account	$ 7,500	$ 7,500	$ 2,500	$ 2,500
Allocated debt	67,500		22,500	
Depreciation Years 1, 2	(10,000)	(10,000)	(10,000)	(10,000)
Interim capital account end of Year 2	$65,000	($ 2,500)	$15,000	($ 7,500)
Relief from partnership debt (constructive cash distribution)	(67,500)	0	(22,500)	0
Constructive cash contribution for guarantee loan payments	7,500	7,500	2,500	2,500
Additional liability relief	(7,500)	(7,500)	(2,500)	(2,500)
Ending capital accounts	($ 2,500)	($ 2,500)	($ 7,500)	($ 7,500)

The capital accounting rules do not take into account a partner's allocated share of partnership-level liabilities. In addition, while the guarantee payments on the loan may be treated as constructive contributions, use of those funds to make actual debt payments does not reduce book capital accounts. Finally, liability relief is treated as a cash distribution reducing tax capital accounts and results in a constructive cash distribution to the partners in excess of basis (represented by the negative ending tax bases).

Under the economic effect test, Viola is entitled to receive $2,500, but there are no partnership assets left with which to make distributions. Because the guarantees were only to the third-party lender and no DRO exists, the lender is paid but Viola cannot obtain the $2,500 owed her, and Tom has an extra $2,500 deduction. The economic effect test is not satisfied through the guarantees.

Example 23. Curative Allocation. Because the depreciation allocations in **Example 22** do not satisfy the economic effect test, they must be reallocated in accordance with the partners' interests in the LLC. This requires $5,000 of depreciation in Years 1 and 2 to be reallocated to Viola (again ignoring the failure to satisfy the economic effect test in Year 1). This results in negative capital account balances for both partners and matching income tax losses in proportion to their interests in the LLC.

	Viola		Tom	
	Basis	Book	Basis	Book
Initial capital account	$ 7,500	$ 7,500	$ 2,500	$ 2,500
Allocated debt	67,500		22,500	
Depreciation Years 1, 2	(15,000)	(15,000)	(5,000)	(5,000)
Interim capital account end of Year 2	$60,000	($ 7,500)	$20,000	($ 2,500)
Liability relief	(67,500)	0	(22,500)	0
Constructive cash contribution for guarantee payments	7,500	7,500	2,500	2,500
Additional liability relief	(7,500)	(7,500)	(2,500)	(2,500)
Ending capital accounts	($ 7,500)	($ 7,500)	($ 2,500)	($ 2,500)

Alternate Economic Effect Test. The **alternate economic effect test**[138] is classically used by LLPs and generally appears to be used for LLCs. The first two requirements for economic effect (maintenance of capital accounts and positive account liquidating distributions) must be satisfied.[139] Instead of a DRO, however, the partnership agreement can provide for a **qualified income offset (QIO).**[140] This is a provision in the partnership agreement that satisfies the following requirements.

- No allocation can be made to a partner with a QIO that causes or increases a deficit balance in that partner's capital account as of the end of the partnership tax year to which the allocation relates.[141]
- The partnership agreement must provide that a partner who unexpectedly receives allocations or distributions resulting in a deficit capital account is allocated pro rata items of partnership income and gain in an amount and manner sufficient to eliminate the deficit balance as quickly as possible.[142]

In determining the capital account of a partner with a QIO at the end of a tax year for allocation purposes, the regulations require the capital account to be reduced first to reflect the following adjustments that are **reasonably expected** at the end of the year to be made in subsequent years.[143]

- Oil and gas depletion
- Losses and deductions allocated to the partner under the family partnership rules, the rules governing retroactive allocations, and the rules governing disproportionate distributions of unrealized receivables and substantially appreciated inventory
- Distributions the partner will receive that exceed reasonably expected increases in the partner's capital account in the same year as the subsequent distribution

Observation. The **income allocations** are for **both tax and capital account purposes,** but distributions based on that income are still in accordance with the partnership agreement.[144] This is because a partner with a deficit capital account has essentially borrowed from the other partners and is therefore required to pay them back.

138. Treas. Reg. §1.704-1(b)(2)(ii)(d).
139. Treas. Reg. §§1.704-1(b)(2)(ii)(d)(1) and (2).
140. Treas. Reg. §1.704-1(b)(2)(ii)(d)(3).
141. Ibid.
142. Treas. Reg. §1.704-1(b)(2)(ii)(d).
143. Ibid.
144. Treas. Reg. §§1.704-1(b)(2)(ii)(d)(3)–(6).

The reason depletion and the other listed allocations are considered "unexpected" is that they are governed by rules that allocate them independently of the partnership agreement. Thus, the application of any one of these allocations for a partnership year creates unique, special allocations that are separate from or that override normal allocations for that year. Because these allocations occur without regard to their economic effect, special allocations are necessary to eliminate the deficits as quickly as possible.

It is important to understand that "unexpected" does not include such events as an unforeseen loss from the normal business operations of the partnership. However, a partner subject to the alternate economic effect test and who has a zero or deficit capital account for any year is prevented from being allocated any of the "usual" partnership deductions and losses attributable to its normal operations, even if they are unexpected in an economic or business sense.[145]

The alternate economic effect test is **applied on an annual basis.**[146] The test may therefore be satisfied in some years but not in others, or may be only partially satisfied in a year. To the extent the test is not satisfied in any year, special allocations are prohibited unless they satisfy the economic effect requirement in some other manner, such as economic effect equivalence (discussed later).

The following examples illustrate the alternate economic effect test.

Example 24. Alternate Economic Effect Allocation. Waldo and Amy form an LLC organized as a partnership with cash contributions of $40,000 each. The LLC uses these funds to buy depreciable personal property for $80,000. All tax items are to be divided equally between Waldo and Amy except depreciation, which is allocated entirely to Waldo. Other income and expenses are equal and the depreciation deduction is in excess of those items. Assume the operating agreement satisfies the alternate economic effect test.

Depreciation for the first year is $20,000 and the entire amount is allocated to Waldo. The allocation has economic effect.

	Waldo		Amy	
	Basis	Book	Basis	Book
Initial capital account	$40,000	$40,000	$40,000	$40,000
Depreciation	(20,000)	(20,000)	0	0
Capital account end of Year 1	$20,000	$20,000	$40,000	$40,000

145. Ibid.

146. Ibid.

Example 25. Partial Alternate Economic Effect Allocation. Use the same facts as **Example 24.** The LLC has a $25,000 depreciation deduction in Year 2 allocated entirely to Waldo. Because this causes Waldo's capital account to have a deficit of $5,000 ($20,000 capital account end of Year 1 – $25,000 depreciation), the allocation is valid only to the extent of $20,000. The remaining $5,000 of depreciation must be reallocated in accordance with the partners' interest in the partnership.

The regulations determine the partners' interests in the partnership by assuming the property is sold at the end of Year 2 for $35,000, its adjusted basis. (This conforms to the value equals basis rule discussed later in the section entitled "Substantial Effect.") The entire $35,000 is distributed to Amy, who has a $40,000 capital account, and none to Waldo, who would have a $5,000 deficit capital account if the entire amount of depreciation were allocated to him. Amy, not Waldo, would then bear the economic burden of $5,000 of the depreciation. This $5,000 depreciation is reallocated from Waldo to Amy. Waldo is allocated the remaining $20,000 of depreciation, bringing his capital account at the end of Year 2 to zero. If the LLC's net income in Year 3 before depreciation is zero, no depreciation is allocated to Waldo in Year 3.

	Waldo		Amy	
	Basis	Book	Basis	Book
Initial capital account	$40,000	$40,000	$40,000	$40,000
Depreciation Years 1 and 2	(40,000)	(40,000)	(5,000)	(5,000)
Capital account end of Year 2	$ 0	$ 0	$35,000	$35,000

Example 26. Invalid Allocation under Alternate Economic Effect. Use the same facts as **Example 25** except that the depreciation deduction for Year 2 is $20,000 instead of $25,000. In addition, the property is sold for $35,000 at the beginning of Year 3, which results in a $5,000 tax loss ($35,000 sales price – ($80,000 cost of property – $40,000 total depreciation for Years 1 and 2)), and the partnership is liquidated. Allocations in accordance with the partnership agreement result in the following capital accounts after the sale.

	Waldo		Amy	
	Basis	Book	Basis	Book
Capital account beginning of Year 2	$20,000	$20,000	$40,000	$40,000
Depreciation Year 2	(20,000)	(20,000)	0	0
Capital account end of Year 2	$ 0	$ 0	$40,000	$40,000
Loss on sale	(2,500)	(2,500)	(2,500)	(2,500)
Interim capital account before liquidation	($ 2,500)	($ 2,500)	$37,500	$37,500

The $35,000 of sale proceeds are distributable entirely to Amy because only she has a positive capital account. However, Amy is entitled to $37,500. The $2,500 loss allocated to Waldo is improper because it is Amy, not Waldo, who bears the economic loss attributable to that deduction. Therefore, the entire $5,000 loss must be allocated to Amy. In addition, Waldo is unable to use the deduction because he has zero basis. The revised capital accounts are as follows.

	Waldo		Amy	
	Basis	Book	Basis	Book
Capital account beginning of Year 2	$20,000	$20,000	$40,000	$40,000
Depreciation Year 2	(20,000)	(20,000)	0	0
Capital account end of Year 2	$ 0	$ 0	$40,000	$40,000
Loss on sale	0	0	(5,000)	(5,000)
Interim capital account before liquidation	$ 0	$ 0	$35,000	$35,000

Example 27. Qualified Income Offset. Use the same facts as **Example 26.** At the end of Year 2, Waldo's capital account is zero and Amy's is $40,000. In Year 3, the partnership borrows $20,000 (which is unforeseen at the end of Year 2) and distributes $10,000 each to Waldo and Amy. In addition, in Year 3, the partnership has income of $50,000, expenses (exclusive of depreciation) of $50,000, and depreciation of $20,000.

Waldo's capital account has unexpectedly become negative because of the $10,000 distribution. The QIO therefore requires that $10,000 of partnership gross income be allocated to Waldo to restore the deficit to zero. This allocation reduces the partnership's gross receipts from $50,000 to $40,000, giving the partnership a $10,000 loss before the $20,000 depreciation deduction.

The $10,000 gross income allocation restores Waldo's deficit capital account to zero. However, no losses can be allocated to him because of the zero capital account. The $10,000 loss and $20,000 of depreciation must therefore be allocated entirely to Amy, who has a $30,000 capital account after the $10,000 distribution. After the $10,000 loss and $20,000 depreciation are allocated to Amy, her capital account is also zero at the end of Year 3.

Example 28. Allocation in Accordance with Partners' Interests in Partnership. Use the same facts as **Example 27,** except the partnership had $40,000 of gross income instead of $50,000 and $10,000 of the $40,000 is specially allocated to Waldo. Losses and deductions of the partnership for the year total $40,000. The first $30,000 is allocated entirely to Amy, reducing her capital account to zero. Because both partners now have a zero capital account, the remaining $10,000 of the loss must be allocated in accordance with the partners' interests in the partnership. Based on their equal capital contributions and share of items other than depreciation, the $10,000 excess is allocated $5,000 to each partner. This leaves each partner with a $5,000 deficit capital account at the end of Year 3.

Economic Effect Equivalence. Economic effect equivalence is sometimes referred to as "dumb but lucky." It applies to allocations that fail the economic effect or alternate economic effect tests. As long as the partners can demonstrate that the economic effect of the allocation is equivalent to the results that would have occurred under either of the two tests, the allocation is accepted. This requires the partners to show that a liquidation of the partnership in the current or any future year would have the same economic effect as if the partnership agreement contained a requirement for capital accounts, liquidating distributions with respect to positive capital accounts, and a DRO.[147]

Substantial Effect

To satisfy the substantial economic effect requirement, not only must special allocations have economic effect but the economic effect must be **substantial.**[148] This is a **separate requirement.** An allocation that has economic effect may not have a substantial economic effect. An economic effect is substantial only if it has a **substantial impact on the dollar amounts** the partners will receive independently of tax consequences.[149]

For purposes of determining substantial effect, **value generally equals basis.** This means the FMV of assets is presumed to be equal to their adjusted bases. If book value differs from adjusted basis, however, book value is used instead.[150] This rule is intended to prevent partnerships from attempting to justify special allocations based on anticipated increases in the value of partnership assets.[151]

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

148. Treas. Reg. §1.704-1(b)(2)(i).

149. Treas. Reg. §1.704-1(b)(2)(iii)(a).

150. Treas. Reg. §1.704-1(b)(2)(iii).

151. Ibid.

The regulations describe three different types of allocations that **lack substantial economic effect.**

- **After-tax economic consequences.** The allocation is not substantial if, at the time the allocation becomes part of the partnership agreement:
  - The after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation was not contained in the partnership agreement; and
  - There is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished.[152]
- **Shifting allocations.** These are special allocations that occur within a tax year that have the same effect on partners' capital accounts as if the special allocations had not been made but that result in a lower overall income tax liability for the partners than would have occurred without the allocations.[153]
- **Transitory allocations.** These are special allocations that occur over more than one tax year. At the end of this period, the partners' capital accounts are substantially the same as they would have been without the special allocations but the partners' overall tax liability is less than it would have been without the allocations.[154]

In applying the substantial effect rules, the "nonpartner" individual tax attributes of a partner that are unrelated to their status as a partner must be taken into account.[155] This includes such factors as whether a partner is subject to tax or is tax-exempt, is insolvent or in bankruptcy, or has a net operating loss carryover from an activity other than the partnership.

> **Note.** There appears to be no legal means under the Code, however, for a partnership to force an individual partner to disclose such information.

Shifting Allocations. Shifting allocations are special allocations of tax items within a single tax year that have no different effect on the partners' year-end capital accounts. This means that the partners' capital accounts would have been the same without the special allocations. If this is the case, there is a strong presumption that the special allocations lack substantial economic effect. However, the partners can rebut the presumption by showing that facts and circumstances indicate that a strong likelihood of a shifting allocation did not exist at the time the provision for the allocation became part of the partnership agreement.

To apply the shifting allocation test, the partners' year-end capital accounts with the special allocation must be compared to what their capital accounts would have been without the allocation. If there is no substantial difference, the partners' tax liabilities with and without the allocation must then be compared, taking into account each partner's nonpartnership tax attributes.[156]

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152. Treas. Reg. §1.704-1(b)(2)(iii)(a).
153. Treas. Reg. §1.704-1(b)(2)(iii)(b).
154. Treas. Reg. §1.704-1(b)(2)(iii)(c).
155. Treas. Reg. §1.704-1(b)(2)(iii).
156. Treas. Reg. §1.704-1(b)(2)(iii)(b).

Example 29. Shifting Allocation. James and Sharon form a partnership and contribute equal amounts to its capital. The partnership agreement satisfies the requirements of the general economic effect test. The partnership agreement also provides that James and Sharon share equally in all items of partnership income and loss.

The partnership invests equally in tax-exempt bonds and corporate stock. For its first year, James expects to be in a substantially higher marginal tax bracket than Sharon. The partnership agreement is modified for the first year to allocate the first $100,000 of tax-exempt interest for that year 90% to James and 10% to Sharon and to allocate the first $100,000 of corporate dividends 10% to James and 90% to Sharon. All other items are shared equally between the two.

At the beginning of the tax year, when the agreement was modified, there was a strong likelihood there would be at least $100,000 each of tax-exempt interest and corporate dividends. Although these allocations would have economic effect, the economic effect is not substantial because there was a strong likelihood that the amendment would not alter the before-tax economic arrangements of the partners. However, the allocation would result in a lower total tax liability. Because the offsetting allocations occur in the same tax year, they are shifting allocations.

Transitory Allocations. Transitory allocations occur over more than one tax year. Otherwise, they are analyzed in essentially the same manner as shifting allocations. There are two exceptions to the transitory allocation rules.[157]

1. An allocation is not considered transitory if there is a strong likelihood it will not be largely offset within five years (determined on a first-in, first-out basis).
2. An allocation is not considered transitory if the partnership activity is of a sufficiently risky nature that there is not a strong likelihood that there will be a future offsetting allocation.

Example 30. Transitory Allocation. Use the same facts as **Example 29,** except the partnership owns depreciable real property generating $50,000 in annual depreciation deductions. Because James expects to be in a substantially higher marginal tax bracket than Sharon during the partnership's first tax year, they agree to allocate the first year of depreciation deductions to James and the second year of depreciation deductions to Sharon. All other items are shared equally, and this allocation has economic effect.

At the time the provision for the allocations of depreciation deductions was added to the agreement, there is a strong likelihood that the capital accounts of James and Sharon, after reflecting these allocations, would not differ substantially from what would have happened if the allocations were not made. Moreover, the overall tax liability of the two partners is reduced by such allocations. The allocations are therefore transitory because the offsetting allocations occur over a period of more than one tax year.

IRC §704(c) ALLOCATIONS

The purpose of IRC §704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain, loss, income, or deductions. Under §704(c)(1)(A), a partnership must allocate income, gain, loss, and deductions with respect to property contributed by a partner to the partnership back to the contributing partner. This is done to take into account any variation between the adjusted basis of the property and its FMV at the time of contribution. Such allocations must be made using a reasonable method that is consistent with the purpose of §704(c). These allocations are **mandatory,** whether they are contained in the partnership agreement or not.

157. Treas. Reg. §§1.704-1(b)(2)(iii)(c) and 1.704-1(b)(5), Example 3.

The built-in gain on §704(c) property is the excess of the property's book value over the contributing partner's basis at the time of contribution. The built-in gain is thereafter reduced by decreases in the difference between the property's book value and adjusted basis. The built-in loss on §704(c) property is the excess of the contributing partner's basis over the property's book value at the time of contribution. The built-in loss is thereafter reduced by decreases in the difference between the property's adjusted basis and book value.[158]

Example 31. Willard contributes $100 of cash basis accounts receivable and $40 of accounts payable to a partnership in exchange for a partnership interest. His capital account is credited with $60, the net FMV. Willard's basis, however, is zero. The $100 receivable has a built-in gain and the $40 payable has a built-in loss. Income resulting from collection of the $100 of receivables and deductions resulting from the $40 of payables existing on the contribution date must be specially allocated back to Willard. Collection of receivables and payment of payables arising after Willard's contribution date are allocated among the partners in proportion to their interests.

Example 32. Use the same facts as **Example 31,** except Willard contributes property with an FMV of $100 and an adjusted basis of $40. Therefore, the property has $60 of built-in gain.

If the property is later sold for $150, the first $60 of gain must be specially allocated to Willard. The remaining $50 of gain is allocated among the partners in proportion to their interests.

If a partner transfers all or a portion of their partnership interest to another partner, IRC §704(c) built-in gains and losses of the transferor partner must be allocated to the transferee.[159] If property with §704(c) gain or loss is disposed of in a nonrecognition transaction, the property acquired in the transaction substitutes for that property.[160]

Although no particular method is required by the Code or regulations, the regulations set out three methods for making the §704(c) allocations that generally are considered to be reasonable.[161] The actual application of these rules is complicated and beyond the scope of these materials. What is most important to remember is that if the partnership sells §704(c) property and recognizes gain or loss, any built-in gain or loss on the property must be allocated to the contributing partner.[162] In addition, a sale of a proportionate interest requires a proportionate allocation.

Observation. It is important to be able to recognize circumstances involving §704(c) assets because the existence of book-tax disparities has a significant effect on the proper maintenance of capital accounts and allocations of minimum gain under the nonrecourse debt rules. In addition, Schedule K-1 (Form 1065), part II, item M, asks whether the partner contributed property with a built-in gain or loss.

158. Treas. Reg. §1.704-3(a)(3)(ii).

159. Treas. Reg. §1.704-3(a)(7).

160. Treas. Reg. §1.704-3(a)(8)(i).

161. Treas. Reg. §§1.704-3(b)–(d).

162. Treas. Reg. §1.704-3(b)(1).

DISTRIBUTIONS, DISPOSITIONS, AND TERMINATIONS

The general rule of partnership taxation is that neither gain nor loss is recognized by the partnership or by the partners with respect to distributions. Exceptions are provided in the following situations.

- Distributions of contributed property with built-in gain or loss under IRC §704
- Distributions of cash in excess of basis under IRC §731
- Certain distributions of assets with pre-contribution built-in gain under IRC §737
- Payments to a retired partner under IRC §736
- Certain distributions of unrealized receivables under IRC §751
- Certain liquidating distributions under IRC §731

A partner's partnership interest can be sold to a third party, including one or more other partners. This is generally treated as the sale or exchange of a capital asset rather than as a distribution but is subject to ordinary income recharacterization to the extent of the partner's share of unrealized receivables under §751 (discussed later under "Collapsible Provisions").[163]

A current distribution is one made to a partner who continues to be a partner following the distribution. A liquidating distribution is one that terminates a partner's interest in the partnership. Although a current distribution may be made in connection with a reduction of a partner's interest in the partnership, as long as the partner continues as a partner, it is treated as a current distribution.

Payments made in liquidation of a partner's interest in the partnership are between the partnership and the partner and are governed by §736 and are generally treated as distributions. The sale of a partnership interest is between the selling partner and a third party other than the partnership and falls under the provisions of §741. The tax treatment of liquidations and of sales may have important differences, which are discussed in the following material.

DISTRIBUTIONS

Cash Distributions

IRC §731(a) provides that distributions of money to partners (including liability relief) is tax-free to the extent of the partner's outside basis in the partnership. For this purpose, the FMV of marketable securities distributed to the partner may be treated as money.[164] The partner's basis is reduced to the extent of the money distributed. Distributions of money in excess of basis are treated as gain from a constructive sale of the partnership interest. This results in short- or long-term capital gain except to the extent such distributions are governed by §§736, 737, and 751.[165] If both money and property are distributed, the partner's basis is always reduced first to the extent of money distributed.[166] No loss can be recognized with respect to current (as opposed to liquidating) distributions.[167] The partnership recognizes neither gain nor loss on a distribution.[168]

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163. IRC §741.
164. IRC §731(c)(1). Certain exceptions are provided for securities distributed to the contributing partner and for investment partnerships.
165. IRC §731(d).
166. IRC §732(a)(2).
167. IRC §731(a)(2).
168. IRC §731(b).

Note. Although money distributions in excess of a partner's basis are treated as the sale or exchange of a capital asset,[169] the look-through rule for capital gain rates (discussed later) does not apply to the "redemption" of the partnership interest.[170] Although the term **redemption** is not specifically used under §736 to describe liquidation of a partner's interest, the substance of those transactions should be treated as a redemption for this purpose.

Example 33. Doris has a partnership basis of $20,000, and she receives a cash distribution of $25,000. She has held the partnership interest more than one year. The first $20,000 of the distribution is tax-free, and Doris's basis is reduced from $20,000 to zero. The remaining $5,000 of distribution is treated as though Doris received it in exchange for a sale of her partnership interest. This part of the distribution is long-term capital gain.

Property Distributions

The manner in which nonrecognition of property distributions is achieved is typical of the tax treatment of partnerships. IRC §732(a) provides that the basis of property other than money distributed as part of a current distribution is its adjusted basis to the partnership immediately prior to the distribution. However, this basis may not exceed the distributee-partner's basis in the partnership immediately prior to the distribution and after the reduction for any money distributed.

If the distributee-partner's basis in the partnership is less than the bases in properties distributed (after reduction for money distributed), the partner's basis is first allocated among unrealized receivables and inventory. Any remaining basis is allocated among other distributed property in proportion to the partnership's bases in the properties. The partner is then left with a zero basis in the partnership.

The point of the property distribution rules is to defer the taxation of any gain or loss on distributed property until the distributee-partner disposes of it.[171] This is in contrast to property distributions from corporations, which are generally treated as being fully taxable to both the corporation and the distributee-shareholder.[172]

Example 34. Scott receives a **current distribution** from a partnership at a time when his basis in the partnership is $10,000. The distribution consists of $7,000 of cash and IRC §1231 property (property used in a trade or business and held for more than one year) with an adjusted basis of $5,000 and an FMV of $9,000. Scott recognizes no gain because the $7,000 cash received does not exceed his $10,000 basis in the partnership. Scott's partnership basis is reduced from $10,000 to $3,000. His remaining $3,000 partnership basis is substituted as his basis in the §1231 property.

If Scott were then to sell the property for its $9,000 FMV, he would recognize $6,000 of gain. This is because Scott originally received a distribution with a total value of $16,000 when he had only $10,000 of basis, but he was not taxed at that time for the distribution in excess of his basis.

169. IRC §731(a).

170. Treas. Reg. §§1.1(h)-1(b)(2)(ii) and (b)(3)(ii).

171. Treas. Reg. §1.731-1(a)(1)(i).

172. IRC §311.

Example 35. Renee has a partnership basis of $15,000. She receives a distribution consisting of $5,000 of cash, inventory with an adjusted basis of $6,000, and two pieces of real property. Property A has a partnership basis of $6,000, and Property B has a partnership basis of $2,000. Renee's basis in the partnership is first reduced from $15,000 to $10,000 by the cash distribution. Her remaining $10,000 basis is first allocated to the inventory, giving it a full carryover basis of $6,000. Her remaining $4,000 of basis is allocated between the two pieces of real property in proportion to their bases in the hands of the partnership prior to the distribution. Thus, Property A receives a basis of $3,000 ($4,000 remaining basis × ($6,000 Property A basis ÷ $8,000 total partnership basis for Properties A and B)). Property B receives a basis of $1,000 ($4,000 remaining basis × ($2,000 Property B basis ÷ $8,000 total partnership basis for Properties A and B)).

If distributed property is subject to a liability assumed by the distributee-partner, the partner's basis in the partnership is:

1. Increased by the liabilities assumed in connection with the distribution,[173]
2. Decreased by the partner's resulting reduction in partnership liabilities,[174] and
3. Decreased by the basis of the distributed property.[175]

Example 36. Ryan has a partnership basis of $3,000. He receives a current distribution of property with an FMV of $12,000. The property has an adjusted basis to the partnership of $5,000 and is subject to a liability of $10,000. At the time of distribution, $6,000 of the liability was included in Ryan's basis. He receives a carryover basis of $5,000 in the distributed property and has a $2,000 basis remaining in the partnership ($3,000 initial basis + $10,000 of liabilities assumed – $6,000 decrease in partnership liabilities – $5,000 basis in distributed property). Ryan's remaining $2,000 basis in the partnership interest is because his outside partnership basis cannot be allocated to the distributed property in excess of the partnership's adjusted basis in the property.

173. IRC §752.

174. Ibid.

175. IRC §733(2).

Basis Differences. Special allocation rules apply under §732(c) in situations in which the distributee-partner's partnership basis required to be allocated among the distributed assets is greater (in the case of a liquidating distribution) or less (in the case of current or liquidating distributions) than the partnership's aggregate bases in those assets.

Step 1. These rules allocate a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property, as under the usual rules.

Step 2. To the extent of any basis not allocated in accordance with step 1, basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an **increase,** is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective FMVs.

Example 37. XYZ partnership has two assets, A and B, which are both distributed in liquidation to Yolanda, whose basis in the partnership interest is $55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of $5 and an FMV of $40. Asset B has a basis to the partnership of $10 and an FMV of $10. Yolanda's basis in the partnership is first allocated $5 to asset A and $10 to asset B (their respective adjusted bases to the partnership).

Yolanda's remaining basis in the partnership is $40 ($55 original basis − $15 partnership's total basis in distributed assets). This basis is then allocated to asset A in the amount of its unrealized appreciation of $35 ($5 partnership basis – $40 FMV). No allocation is attributable to asset B for unrealized appreciation because its FMV equals the partnership's adjusted basis in it. The remaining basis adjustment of $5 is then allocated in the ratio of the assets' FMVs. Therefore, the remaining basis is allocated $4 to asset A ($5 basis adjustment × ($40 FMV for asset A ÷ $50 FMV for both assets)) and $1 to asset B ($5 basis adjustment × ($10 FMV for asset B ÷ $50 FMV for both assets)). After these allocations, asset A has a total basis of $44 ($5 + $35 + $4), and asset B has a total basis of $11 ($10 + $1).

Step 3. Any remaining basis adjustment that is a **decrease** arises when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties (nonliquidating distributions). If the partner's basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal to the basis to be allocated, the decrease is allocated in the following order.

- Among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation)
- In proportion to their respective adjusted bases (taking into account the adjustments already made)

Example 38. Omega partnership has two assets, D and E, which are both distributed in liquidation to Gavin, whose basis in the partnership interest is $20. Neither asset consists of inventory or unrealized receivables. Asset D has a basis to the partnership of $15 and an FMV of $15. Asset E has a basis to the partnership of $15 and an FMV of $5. Gavin's $20 basis in the partnership is first allocated to asset D in the amount of $15 and to asset E in the amount of $15 (their respective adjusted bases to the partnership), for a total of $30.

Because Gavin's basis in the partnership interest is only $20, a reduction of $10 ($30 – $20) is required. The entire amount of the $10 decrease is allocated to property E. This is because asset E has unrealized depreciation of $10 ($15 partnership basis – $5 FMV). Asset D has no unrealized depreciation (i.e., its partnership basis is equal to its FMV). Thus, Gavin's basis in asset D is $15, and his basis in asset E is $5 ($15 partnership basis – $10 decrease).

DISPOSITIONS OF PARTNERSHIP INTERESTS

Sale

If a partner sells a partnership interest to a third party who then becomes a new partner, there is clearly a sale of a partnership interest. However, if the partner sells the interest to other partners in the partnership, it is important to distinguish an actual sale of the interest to another person from a liquidation of that interest by the partnership. A sale of a partnership interest is treated as the sale of a capital asset[176] and generates capital gain except to the extent the gain is recharacterized as ordinary income under IRC §751 for the selling partner's share of appreciation in unrealized receivables and inventory. These requirements are discussed later in the section entitled "Compliance — Sales and Exchanges of §751(a) Property."

Although the sale of a partnership interest held for more than one year is the sale of a capital asset, the rates applicable to any long-term capital gain must be determined on a look-through basis. Under this rule, the gain must be allocated to the selling partner's proportionate interest in any partnership collectibles and unrecaptured §1250 gain,[177] with the residual balance treated as long-term capital gain.[178] Both the partnership and the partner are also required to report the partner's share of collectibles gain and unrecaptured depreciation in a manner similar to reporting requirements for gain attributable to unrealized receivables and inventory under §751(a).[179]

Liquidation

IRC §736 governs payments to a "retiring partner" or to the successor in interest of the deceased partner. However, such payments are in fact in liquidation of a partner's or deceased partner's interest in the partnership.[180] A partner "retires" for purposes of subchapter K when they cease to be a partner under state law. The partnership provisions of subchapter K continue to apply to a retiring partner or the successor in interest or estate of a deceased partner, however, until the retiring or deceased partner's interest has been entirely liquidated, unless the successor or estate actually becomes a continuing full partner under state law.

IRC §736(a) Payments. Payments under §736(a) are taxable to the withdrawing partner as a distributive share of partnership income if they are payable **with** regard to partnership profit. They are treated as **guaranteed payments** under IRC §707(c) if payable **without** regard to partnership profit. In either event, §736(a) payments are taxable income to the withdrawing partner and either reduce the distributive share of the remaining partners (if distributions) or are deductible by the partnership (if guaranteed payments).

If a partner receives deferred payments taxable under both §§736(a) and (b) (discussed later), any payment must be allocated proportionately between the two as described in the regulations or in such other manner as the partnership and retired partner or successors of a deceased partner may agree in writing.[181]

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176. IRC §741.

177. Treas. Reg. §1.1(h)-1(b).

178. Treas. Reg. §1.1(h)-1(a).

179. Treas. Reg. §1.1(h)-1(e).

180. IRC §736(a).

181. Treas. Reg. §1.736-1(b)(5)(iii).

Example 39. ABC is a personal service partnership in which capital is not a material income-producing factor. ABC's balance sheet follows.

Assets

	Adjusted Basis	FMV
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital assets and §1231 assets	20,000	23,000
Total	$33,000	$66,000

Liabilities and Capital

	Adjusted Basis	FMV
Liabilities	$ 3,000	$ 3,000
Capital:		
Alton	10,000	21,000
Brad	10,000	21,000
Carla	10,000	21,000
Total	$33,000	$66,000

Alton retires from the partnership in accordance with an agreement under which his $1,000 share of liabilities is assumed by the other partners. In addition, Alton receives $9,000 the year that he retires plus $10,000 in each of the two succeeding years. Thus, the total that he receives is $30,000 ($29,000 in cash + $1,000 in liability relief). His basis is $10,000 plus a $1,000 share of liabilities.

Under the agreement terminating Alton's interest, the value of his interest in §736(b) partnership property is $12,000 (1/3 × ($13,000 cash + $23,000 FMV of capital assets and §1231 assets). Alton's share in unrealized receivables is not included in the interest in partnership property described in §736(b). Because the basis of Alton's interest is $11,000, he realizes a capital gain of $1,000 ($12,000 – $11,000) from the disposition of his interest in partnership property.

The remaining $18,000 ($30,000 total he receives – $12,000 for 736(b) property) constitutes payments under §736(a) that are taxable to Alton as guaranteed payments under §707(c) because they are fixed in amount and not dependent on partnership profit. The payment for the first year is $10,000 ($9,000 in cash + $1,000 liability relief). Thus, unless the partners agree to allocate annual payments otherwise, each annual payment of $10,000 is allocated as follows.

- $6,000 ($18,000 payment under §736(a) ÷ $30,000 total payments) × $10,000) is a §736(a) ordinary income payment
- $4,000 ($12,000 payments under §736(b) ÷ $30,000 total payments) × $10,000) is a payment for an interest in §736(b) partnership property.

The partnership may deduct the $6,000 guaranteed payment made to Alton in each of the three years.

The gain on the payments for partnership property is determined under §731 in the same manner as for any distribution. Therefore, Alton treats only $4,000 of each payment as a distribution in a series in liquidation of his entire interest. Under §731, Alton has a capital gain of $1,000 (($23,000 FMV of capital and §1231 assets – $20,000 adjusted basis) ÷ 3) when the last payment is made. However, if Alton elects, he may treat each $4,000 payment as follows.

- $333 as capital gain (one-third of the total capital gain of $1,000)
- $3,667 as a return of capital

Example 40. Use the same facts as **Example 39,** except the agreement between the partners provides that payments to Alton for three years are a percentage of annual income instead of a fixed amount. All payments received by Alton up to $12,000 (his share of §736(b) property) are treated under §736(b) as payments for his interest in partnership property. Alton's gain of $1,000 is taxed only after he receives his full basis under §731. Because the payments are not fixed in amount, the election to recover basis proportionately is not available. Any payments in excess of $12,000 are treated as a distributive share of partnership income to Alton under §736(a).

Example 41. Use the same facts as **Example 39,** except capital is an income-producing factor, Alton is considered a general partner, and the partnership agreement provides that the payment for his interest in partnership property includes payment for his interest in partnership goodwill.

At the time of Alton's retirement, the partners determine the value of partnership goodwill is $9,000. Therefore, the value of Alton's interest in partnership property under §736(b) is $15,000 ($^1/_3$ × ($13,000 cash + $23,000 capital assets and §1231 assets + $9,000 goodwill)). From the disposition of Alton's interest in partnership property, he realizes a capital gain of $4,000 ($15,000 value – $11,000 basis). The remaining payments of $15,000 ($30,000 total payments – $15,000) constitute ordinary income under §736(a), which are taxable to Alton as guaranteed payments under §707(c).

IRC §736(b) Payments. Liquidating distributions to a partner for the partner's interest in partnership property are subject to §736(b). This results in **capital gain or loss.** An exception is provided if there are unrealized receivables or inventory items. In that case, the partner is required to treat as ordinary income under §751 an amount equal to what the partner's share of gain would have been if the partnership disposed of all of its receivables and inventory in a taxable sale at FMV.[182] The partner therefore has ordinary income to the extent of that amount.[183] The remainder of the §736(b) liquidating distribution is governed by the provisions of §731 (discussed previously).[184] The constructive sale treatment is not applicable to distributions of §751 property contributed to the partnership by the distributee-partner or to distributions treated as distributive shares of partnership income or guaranteed payments under §736(a).[185]

Under §736(b), liquidating distributions to a partner are treated in the same manner as current distributions under §731. This means they are generally tax-free except to the extent the liquidated partner receives cash in excess of basis. Because a **liquidating distribution** is a termination of a partner's interest, however, the distributee-partner is required to **substitute** the distributee's **outside basis** in the partnership immediately before the distribution as the partner's basis in the property distributed by the partnership.[186] In contrast, a **current distribution requires** the distributee to take the **carryover basis** of the partnership.[187]

Although liquidating distributions use a substituted rather than a carryover basis, the actual basis allocation rules are the same for both liquidating and current distributions as discussed previously. In addition, unlike current distributions, a partner may be permitted to recognize a loss on a liquidating distribution if the distribution: [188]

- Consists solely of money (for this purpose not including marketable securities), unrealized receivables, and inventory; and
- The partner's basis immediately before the distribution exceeds the money and the basis of the receivables and inventory distributed.

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182. Treas. Reg. §1.751-1(a)(2).
183. Treas. Reg. §1.751-1(a)(1).
184. Treas. Reg. §1.736-1(b)(1).
185. IRC §751(b)(2).
186. IRC §732(b).
187. IRC §732(a).
188. IRC §731(a)(2).

Example 42. David receives a **liquidating distribution** from a partnership at a time when his basis in the partnership is $10,000. The distribution consists of $7,000 of cash and §1231 property (property used in a trade or business and held for more than one year) with an adjusted basis of $5,000 and an FMV of $9,000. David recognizes no gain because the cash he received does not exceed his basis. His partnership basis is reduced from $10,000 to $3,000 and the $3,000 of remaining partnership basis is substituted as his basis in the §1231 property.

If David were then to sell the property for its $9,000 FMV, he would recognize $6,000 of gain. This is because David originally received a distribution with a total value of $16,000 against only $10,000 of basis but was not taxed at that time.

Unrealized receivables and partnership goodwill are specifically excluded from the scope of §736(b) unless an exception for goodwill applies (discussed later).[189] Therefore, they are treated as a distributive share of partnership income if the amount paid depends on the partnership's income or as a guaranteed payment if the amount is determined without regard to the partnership's income.[190]

Sale versus Liquidation of Interest

As discussed previously, the sale of a partnership's interest is treated as the sale of a capital asset[191] resulting in capital gain except to the extent the gain is recharacterized as ordinary income under IRC §751. **Liquidation** of the interest of a **deceased or retiring partner** is treated as a distribution and is governed by §736. If the partnership interest is liquidated for cash, it is generally only a matter of distinguishing between payments under §§736(a) and 736(b). The tax treatment of the two can differ significantly.

A partner selling a partnership interest can report any capital gain under the installment rules of §453 (but not ordinary income attributable to unrealized receivables[192] and inventory[193] under §751). If there is a deferral of §736(b) payments, the rules generally provide that the withdrawing partner recover basis first and then report gain because the normal distribution rules of IRC §731 require this.[194] However, the withdrawing partner can attach an election to their return for the first year payments are received to report the gain and basis recovery ratably over the period that payments are received.[195] Such flexibility is not permitted if a partner sells an interest under §741 because it is a sale or exchange.[196] In addition, an installment sale of a partnership interest may be subject to the imputed interest rules,[197] while deferred payments for liquidation of a partnership interest are not because they are distributions under §731 and not the result of a sale or exchange.[198]

189. IRC §736(b)(2).

190. IRC §736(a).

191. IRC §741.

192. *Mingo v. Comm'r,* 773 F.3d 629 (5th Cir. 2014).

193. IRC §453(b)(2)(B).

194. Treas. Reg. §1.736-1(b)(6).

195. Ibid.

196. IRC §1001(a).

197. IRC §483.

198. Treas. Reg. §1.708-1(b)(2).

A **selling partner** is required to recharacterize gain as ordinary income to the extent of the partner's share of unrealized receivables.[199] The remaining partners receive no benefit from such recharacterization, unless a §754 election is in effect, and then only the purchasing partner or partners receive a benefit (discussed previously in the section entitled "IRC §754 Election"). In a liquidation, a partner's interest in unrealized receivables may be treated as a §736(a) payment for partnership property, thereby reducing ordinary income to the remaining partners because the payments reduce the distributive shares of the remaining partners or are deductible by the partnership as a guaranteed payment.[200]

If there is a sale or exchange of 50% or more of the total interests in partnership capital or profits within a 12-month period, a technical termination of the partnership occurs under IRC §708. Although the consequences of such an event are not as bad as they were in the past (discussed later), there are still certain tax issues associated with technical terminations. The liquidation of a partner's interest under §736 is not a sale or exchange for purposes of §708, even if it involves 50% or more of the total partnership interests.[201]

Because of the differing tax consequences, it is important to be able to distinguish a sale from a liquidation of the interest. The general rule is that the partners are free to determine the form in which to cast the transaction because of their adverse tax interests. Courts generally accept an unambiguous agreement characterizing the transaction. If it is not clear, the transaction is examined for its substance under a facts-and-circumstances determination.[202]

Goodwill. The **sale** of a partnership interest to a third party under §741 may include an amount for the selling partner's share of the partnership's goodwill. This is treated as capital gain to the selling partner.[203] If a §754 election is in place (discussed earlier), the purchaser may be treated as having a basis in partnership goodwill amortizable under IRC §197 to the extent basis is allocable to goodwill pursuant to that election.[204]

In a **liquidation**, goodwill may be treated under §736(a) as a distributive share of partnership income or as a guaranteed payment except to the extent the partners have agreed in the partnership agreement that it will be treated as a §736(b) payment for an interest in partnership property. This applies only if capital is a material income-producing factor in the partnership and the partner is considered a general partner.[205] Thus, in a liquidation, the partners have the ability, if capital is as material income-producing factor, to make amounts received for goodwill either capital gain to the withdrawing partner and nondeductible by the partnership or distributive shares or guaranteed payments that reduce the distributive shares of the remaining partners or are deductible by the partnership.[206] If a §754 election is in place, however, the partnership can adjust its inside bases to reflect certain tax consequences to the liquidated partner (discussed earlier). To the extent gain is recognized by that partner on partnership goodwill, the partnership may be able to allocate this to partnership goodwill as a §197 amortizable intangible. This is **not** the case in a partnership in which capital is not a material income-producing factor. Such partnerships are not eligible to treat goodwill as partnership property under §736(b) and must therefore always treat it as a §736(a) payment.

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199. IRC §741.

200. IRC §736(a).

201. Treas. Reg. §1.708-1(b)(2).

202. See, e.g., *Foxman, et al. v. Comm'r,* 41 TC 535 (1964), *aff'd* 352 F.2d 736 (3rd Cir. 1965), *acq.* 1966-2 CB 4.

203. IRC §741.

204. Treas. Reg. §1.755-1(a)(5).

205. IRC §736(b)(3).

206. IRC §736(b)(2)(B).

The IRS has not defined circumstances in which capital is not a material income-producing factor. However, the Conference Committee Report to the Revenue Reconciliation Act of 1993, which enacted §736(b)(3), states the following.

> *For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice.*[207]

Compliance

The instructions for **box 19** (distributions) of Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* identify code A as showing distributions to a partner of cash and marketable securities required to be treated as cash. If distributions of money and the FMV of marketable securities exceeds the partner's adjusted basis in their partnership interest, the instructions say to treat this as the sale of a capital asset on the partner's return. The instructions also say that cash or property distributed in exchange for any part of the partner's partnership interest attributable to the partner's share of unrealized receivables and inventory items is ordinary income (discussed next under "Collapsible Provisions") but provide no directions for reporting these items on the partner's individual return. Presumably, line 21 (other income) of Form 1040, *U.S. Individual Income Tax Return,* would be appropriate.

Code C in **box 19** of Schedule K-1 is used to report the partnership's adjusted basis of property other than money distributed from the partnership to the partner. If there is more than one property, the partnership must report the adjusted basis and FMV of each. The Schedule K-1 instructions describe how the property's basis is determined in the hands of the individual partner based upon whether it is a liquidating or nonliquidating distribution.

Payments made to a retiring partner under §736(a), or the successor, or to the estate of a deceased partner are taxed as **ordinary income.** If payments are based on a share of partnership profit, the partnership issues a Schedule K-1 reflecting the partner's distributive share of partnership items. If the payments are treated as guaranteed payments, the Schedule K-1 should reflect that. In either case, a retiring partner is subject to self-employment (SE) tax under the usual rules if the partner was a general partner, regardless of the fact that the partner is retired.[208] It is possible to structure retirement payments to a retired partner under IRC §1402(a)(10) in such a manner that they will not be subject to SE tax. However, any such plan must comply strictly with the regulations and may not suit the needs of the partnership or retiring partner.[209]

If deferred §736(a) payments are made to a deceased partner's successor, a Schedule K-1 must also be issued showing the payments as either a distributive share of partnership income or a guaranteed payment. The instructions for Form 1065 state that amounts should not be entered on line 14 of the Schedule K-1 for net earnings or loss from self-employment (code A) for any partner that is an estate, trust, corporation, exempt organization, or individual retirement arrangement. If an individual successor in interest to a deceased partner has not been admitted as a substitute partner, there should also be no entry on line 14 because that individual is not a partner[210] and therefore has no SE income under IRC §1402(a) as a partner in the partnership.

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207. HR Rep. No. 103-213 at 698 (1993) (Conf. Rep.). A footnote cites IRC §§401(c)(2) and 911(d) as references.

208. Treas. Reg. §§1.1402(a)-1(b) and 2(d).

209. Treas. Reg. §1.1402-17.

210. IRC §761(b).

COLLAPSIBLE PROVISIONS

Sale or Exchange

Under §741, the sale of a partnership interest is considered the sale of a capital asset. However, rules under §751 recharacterize the gain related to unrealized receivables and inventory items as ordinary income. **The intent of the recharacterization rule is to prevent partners from circumventing ordinary income treatment** that would result from an entity-level sale of those assets by selling the outside partnership interests instead. In addition, **nonliquidating disproportionate distributions that change a partner's share of inventory or unrealized receivables can cause both the distributee-partner and the partnership to recognize gain or loss** under IRC §751. **IRC §751 is referred to as the "collapsible" partnership provision,** and the types of assets that result in ordinary income are commonly called **"hot assets."**

Unrealized receivables are any rights to payment not already included in income for goods delivered or to be delivered to the extent that the payment would be treated as received for property other than a capital asset. They also include rights to payment for services rendered or to be rendered to the extent income arising from such rights to payment was not previously includable in income by the partnership.[211] The rights to payment must have arisen under contracts or agreements in existence at the time of sale even though the partnership may not be able to enforce payment until a later time.[212] Work in progress is an example of such income rights. Unrealized receivables also include any §1245 or §1250 depreciation recapture (as well as other less common forms of recapture) to the extent the partnership would be subject to it for the sale of any partnership asset on the date of transfer.[213]

Inventory items include the usual stock in trade and property held for sale to customers. Inventory also includes any other partnership property which, on a sale or exchange by the partnership, would be considered property other than a capital asset or §1231 property.[214]

Example 43. Claudia, Nancy, and Carey are each one-third partners in an accrual basis partnership. The partnership's balance sheet follows.

Assets

	Basis	FMV
Cash	$ 10,000	$ 10,000
Accounts receivable	5,000	2,500
Trade notes receivable	2,000	2,100
Merchandise on hand	4,000	9,500
Land	80,100	100,100
Total assets	$101,100	$124,200

211. IRC §751(c).

212. Treas. Reg. §1.751-1(c)(1)(ii).

213. IRC §751(c).

214. IRC §751(d).

Capital		
	Basis	FMV
Claudia	$ 33,700	$ 41,400
Nancy	33,700	41,400
Carey	33,700	41,400
Total capital	$101,100	$124,200

The hot assets are the accounts receivable, trade notes receivable, and merchandise. They have a total adjusted basis of $11,000 and an FMV of $14,100.

Claudia sells a one-third interest in the partnership to Wayne for $41,400. Claudia has a gain of $7,700 ($41,400 sale price – $33,700 basis). Her one-third share of the hot assets' FMV is $4,700 and her share of their bases is $3,667. Therefore, Claudia is required to recognize $1,033 of ordinary income under §751 ($4,700 – $3,667). The $6,667 balance of Claudia's gain ($7,700 – $1,033) is capital gain.

Disproportionate Distributions

Disproportionate partnership distributions that change a partner's share of **substantially appreciated inventory** or **unrealized receivables** can cause both the distributee-partner and the partnership to recognize gain or loss.[215] **Substantially appreciated inventory** is inventory with an FMV that is more than 120% of its adjusted basis.[216] **Otherwise,** the rules are generally the same as for distributions under IRC §731 (discussed earlier in the section entitled "Distributions").

Example 44. Scott, Don, and Alan each own a one-third interest in a partnership. The partnership has the following assets.

	Basis	FMV
Cash	$ 6,000	$ 6,000
Inventory	6,000	12,000
Land	9,000	18,000
	$21,000	$36,000

Scott's partnership interest has a basis of $7,000 ($21,000 ÷ 3). All inventory is distributed to Scott in liquidation of his partnership interest. Scott is treated as having exchanged a one-third interest in the cash and the land for a two-thirds increased interest in the inventory. Scott has a gain of $3,000 because he received $8,000 ($^2/_3$ × $12,000) of inventory in exchange for assets with a basis to him of $5,000 ($^1/_3$ × ($6,000 cash + $9,000 land)). The $3,000 gain ($8,000 – $5,000) is capital gain if the land was a capital asset.

The partnership is treated as having received $8,000 (FMV of Scott's $^1/_3$ share of cash and land) in exchange for inventory with a basis of $4,000 (basis of inventory distributed in excess of Scott's one-third share). Thus, the partnership recognizes ordinary income of $4,000.

215. IRC §751(b).

216. IRC §751(b)(3)(A).

Compliance — Sales and Exchanges of §751(a) Property

A transferor-partner selling or exchanging any part of an interest in a partnership that has §751(a) property (unrealized receivables and inventory) at the time of the sale or exchange must notify the partnership in writing of such transfer by the earlier of 30 days after the transfer or January 15 of the calendar year following the transfer.[217] Failure to do so can result in imposition of a $50 penalty on the transferor.[218] The written notification must include the following information.

1. Names and addresses of the transferor and transferee
2. Taxpayer identification numbers of the transferor and the transferee (if known)
3. Date of the transfer

A partnership that has been notified of a §751(a) sale or exchange is required to issue a Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, to the transferor and transferee. Form 8308 is not required to be issued if the sale or exchange is reported by a broker pursuant to IRC §6045. **Form 8308 must be issued to the transferor and transferee by January 31 of the calendar year following the §751(a) transfer.** A copy must also be included with the partnership's Form 1065 by its due date, including extensions. Form 8308 follows.

Form **8308**
(Rev. October 2015)
Department of the Treasury
Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

▶ **Information about Form 8308 and its instructions is at *www.irs.gov/form8308*.**

OMB No. 1545-0123

Name of partnership	Phone number	**Employer identification number**

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state or province, country, and ZIP or foreign postal code

Part I **Transferor Information** (Beneficial owner of the partnership interest immediately before the transfer of that interest)

Name	**Identifying number**

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Notice to Transferors: *The information on this form has been supplied to the Internal Revenue Service. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.*

Statement by Transferor: *The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to his or her return. See* Instructions to Transferors *for more details.*

Part II **Transferee Information** (Beneficial owner of the partnership interest immediately after the transfer of that interest)

Name	**Identifying number**

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Part III **Date of Sale or Exchange of Partnership Interest ▶** ____/____/____

Sign Here Only if You Are Filing This Form by Itself and Not With Form 1065 or Form 1065-B	Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.
	▶ Signature of general partner or limited liability company member ▶ ____/____/____ Date

217. Treas. Reg. §1.6050K-1(d)(1). The materials in this section are based on Treas. Reg. §1.6050K-1.

218. IRC §6723. Treas. Reg. §1.6050K-1(g)(1) and the instructions for Form 8308 incorrectly refer to IRC §6722. This section applies to failure to furnish correct payee statements. Information required to be furnished to the partnership by the transferor is not within the definition of the statement at IRC §6724(d)(2)(P).

A partnership is not required to issue a Form 8308 until it is notified of the exchange. A partnership is notified of the exchange when either: [219]

- A partner has notified it of a covered transfer, or
- The partnership has knowledge that there has been a transfer of a partnership interest or any portion thereof at a time when the partnership had any §751 property.

A partnership may rely on a written statement from the transferor that the transfer was not a §751(a) exchange in the absence of actual knowledge to the contrary.[220] Transfers that are not sales or exchanges (such as gifts) are not reportable.

A §751(a) sale or exchange is a sale or exchange under §741 between the transferor-partner and another person in which any portion of consideration received by the transferor is attributable to §751(a) property. It does not include distributions by partnerships to partners that are treated as sales or exchanges of unrealized receivables and inventory under §751(b).

The definition of a §751(a) transfer in the regulations is **inconsistent** with that in the Form 8308 instructions. The regulations define §751 property for reporting purposes as unrealized receivables (§751(c)) and substantially appreciated inventory (§751(d)).[221] The instructions to Form 8308 define such property simply as unrealized receivables and inventory. The inconsistency is the result of a change in the definition of inventory in §751(a) eliminating the requirement that inventory be substantially appreciated. The regulations under §6050K have not yet been updated to reflect this change, although there are proposed regulations that would do so as well as require the partnership statement to the transferor to include the amount of any gain or loss required to be recognized with respect to §751 property.[222]

HOLDING PERIOD AND CHARACTER OF DISTRIBUTED PROPERTY

In general, a distributee-partner tacks (adds) on the partnership's holding period to the holding period of the distributee-partner.[223]

> **Example 45.** Janelle receives a distribution of a capital asset from a partnership. The partnership held the asset for six months. If Janelle holds the asset for more than six months following distribution and then sells it, she will have a long-term capital gain because the partnership's holding period is tacked on to her holding period.

IRC §735(a) requires any gain or loss on a subsequent disposition of unrealized receivables by a distributee to be treated as ordinary regardless of when it is disposed of. In addition, any gain or loss on a disposition of inventory within five years of distribution must be treated as ordinary. For purposes of measuring the 5-year period, there is no tacking on to holding periods.[224] Although this appears to be the same as the treatment accorded a sale of a partnership interest under §751, there are some important differences.

- Unrealized receivables does not include depreciation recapture, as it does for purposes of §751. That is because the recapture potential carries over in the distributed property.[225]
- Inventory does not include §1231 property that is included within the definition of inventory for purposes of §751 solely because it has not been held for the requisite §1231 holding period.[226]

> **Note.** In some cases, a partner may have a divided holding period in a partnership interest. See Treas. Reg. §1.1223-3 for determining and handling such cases.

219. Treas. Reg. §1.6050K-1(e).

220. Ibid.

221. Treas. Reg. §1.6050K-1(a)(4)(ii).

222. Prop. Treas. Reg. §§1.6050K-1(a)(4)(ii) and (c).

223. IRC §735(b).

224. Ibid.

225. Treas. Reg. §1.1245-3(a)(3).

226. IRC §735(c)(1).

DEATH OF PARTNER

Although the death of a partner may cause the dissolution of a general partnership under state law (but generally not an LLC), there usually is no termination of the partnership for federal income tax purposes.[227] This is true even in the case of the death of one partner in a 2-partner partnership as long as any successor-in-interest of the deceased partner continues to receive payments from the partnership prior to a complete liquidation of the decedent's interest.[228] Payments for a deceased partner's interest in the partnership are considered to be payments under §736 and are taxed accordingly.

The death of a partner also results in a closing of the partnership's tax year for the deceased partner.[229] Any distributive share to that point is included on the decedent's final return and any distributive share after death is reported on the successor's return.[230]

TERMINATION OF PARTNERSHIP

A partnership terminates for federal tax purposes when it winds up its affairs and ceases conducting any business or when there is a 50% or more change in ownership in **both** partnership capital and partnership profits within a 12-month period, even if the partnership's business is thereafter continued by the new and remaining partners.[231] Multiple sales of partnership interests are cumulated to determine whether the 50% threshold has been reached within any consecutive 12-month period.[232] This is commonly referred to as a **technical termination.** Transactions that are **not** treated as sales for this purpose include distributions, gifts, transfers at death, and liquidations of partnership interests.[233] Admissions of new partners causing shifts in partnership interests and contributions of property by an existing partner are nonrecognition events under IRC §721 and are therefore not sales or exchanges covered by IRC §708(b)(1)(B).

> **Note.** While liquidating distributions to a partner under §736 are not treated as sales under §708, the purchase of a partnership interest by another partner under §741 is.[234]

If a partnership is terminated under §708 by a sale or exchange of an interest, the following is deemed to occur.[235]

1. The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership.
2. Immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. In the latter case, the new partnership terminates by virtue of winding up its affairs.

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227. IRC §706(c)(1).
228. Treas. Reg. §1.708-1(b)(1)(i).
229. IRC §706(c)(2)(A).
230. Treas. Reg. §§1.706-1(c)(2)(i) and (ii).
231. IRC §708(b).
232. Treas. Reg. §1.708-1(b)(2).
233. Ibid.
234. Ibid.
235. Treas. Reg. §1.708-1(b)(4).

The consequences of a **technical termination** include the following.

- The new partnership continues to use the **same employer identification number** as the terminated partnership.[236]
- Separate short-year returns are filed for both the terminated and new partnership resulting from a technical termination.[237] The return for the terminated partnership should be marked "final," and the return of the new partnership should be marked "initial." In both cases, the "technical termination" box (item G(6)) on Form 1065 should be checked.
- Generally, no gain or loss is recognized as a result of the deemed contribution and distribution.[238]
- The tax year of the terminated partnership ends for all partners.[239]
- Capital accounts carry over and are not revalued.[240]
- Unless termination occurs on the last day of the partnership tax year, partners' distributive shares of termination are reported on their returns for the year in which the termination occurs.[241] Items are reported by the terminated partnership through the date of the terminating event.[242]
- Unless otherwise provided, any elections by the terminated partnership end because the old partnership is treated as otherwise terminating and a new partnership comes into existence for tax purposes.[243] The new partnership must therefore generally make all new elections (e.g., accounting method, §754 elections, inventory methods, and IRC §179 expensing).
- The new partnership begins new depreciation periods for all the partnership's depreciable tangible assets.[244] This has the effect of stretching out the recovery period of such property beyond its original recovery period. However, the new partnership steps into the shoes of the terminated partnership and must continue amortizing §197 intangibles over the remainder of the terminated partnership's amortization period.[245]
- Qualified bonus depreciation property acquired by the terminated partnership and contributed to the new partnership is not treated as acquired and disposed of in the same tax year solely as a result of a technical termination. The bonus depreciation deduction must be taken by the new partnership even if the property was placed in service by the terminated partnership.[246]
- Because the constructive contribution and distribution are treated as nonrecognition events,[247] basis in partnership assets carries over from the terminated partnership to the new partnership.[248] In addition, holding periods are tacked on for capital and §1231 assets (but not ordinary income assets).[249]

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236. Treas. Reg. §301.6109-1(d)(2)(iii).
237. IRS Notice 2001-5, 2001-1 CB 327.
238. IRC §§721 and 731.
239. Treas. Reg. §1.706-1(c)(1).
240. Treas. Reg. §1.704-1(b)(2)(iv)(l).
241. Treas. Reg. §1.706-1(c)(1).
242. Treas. Reg. §1.708-1(b)(3).
243. Notice of Proposed Rulemaking PS-5-96, Preamble.
244. IRC §168(i)(7).
245. Treas. Reg. §§1.197-1(g)(2)(ii)(A) and (iv).
246. Treas. Reg. §1.168(k)-1(f)(1)(ii).
247. IRC §§721 and 731.
248. IRC §723.
249. IRC §1223(1).

- Because the new partnership resulting from the termination is generally viewed as a new taxpayer and no exception is provided, it must adopt a proper tax year regardless of any previous correct use of a fiscal year.[250]
- If a partnership has in place an inside §754 basis adjustment under IRC §743, this is not affected even if the new partnership does not make a §754 election.[251]
- A §754 election in place on the date of termination is deemed to survive long enough to apply to an incoming partner.[252]
- The new partnership continues the terminated partnership's election to amortize startup and organizational expenses in the same manner and over the same remaining period as the old partnership.[253]
- A technical termination does not affect the amount of built-in gain or loss property under IRC §704(c), but the new partnership is not required to use the same methods as the old partnership's book-tax basis differences in such property.[254]
- A technical termination is not treated as a distribution of §704(c) property within seven years of contribution that triggers recognition of built-in gain or loss to the contributing partner.[255]
- A technical termination does not trigger §731(c) rules regarding distributions of marketable securities.[256]
- The 7-year holding period for determining recognition of precontribution gain on certain distributions under §737 is not affected.[257]

Observation. Some consequences of a technical termination may be undesirable. It may therefore be prudent for planning purposes to stagger changes in ownership so that there is a less than 50% ownership change in any 12-month period.

250. IRC §706(b)(1)(B).
251. Treas. Reg. §1.743-1(h)(1).
252. Treas. Reg. §1.708-1(b)(5).
253. Treas. Reg. §1.708-1(b)(6).
254. Treas. Reg. §1.704-3(a)(2).
255. Treas. Reg. §1.704-4(c)(3).
256. Treas. Reg. §1.731-2(g)(2).
257. Treas. Reg. §1.737-2(a).

The following example from the regulations illustrates a technical termination.[258]

> **Example 46.** Abigail and Bentley each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time Abigail sells her entire 50% interest to Corinne for $15,000 in a transfer that terminates the partnership under IRC §708(b)(1)(B). At the time of the sale, Property X had an adjusted basis of $16,000 and a book value of $16,000 (original $20,000 basis and book value, reduced by $4,000 of depreciation). In addition, Abigail and Bentley each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).
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> Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted basis of Property X in the hands of new AB is $16,000. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination). In addition, Bentley and Corinne each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). The deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership. Additionally, new AB retains the taxpayer identification number of the terminated AB partnership.

In the preceding example, Property X was not IRC §704(c) property in the hands of terminated AB and is therefore not treated as IRC §704(c) property in the hands of new AB. This is true even though Property X is deemed contributed to new AB at a time when the FMV of Property X ($30,000) was different from its adjusted basis ($16,000). That is because property contributed to a new partnership under these termination rules is treated as IRC §704(c) property only to the extent that the property was IRC §704(c) property in the hands of the terminated partnership.

258. Treas. Reg. §1.708-1(b)(4).