Chapter 3: Partnership Basics

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Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following 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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THE NATURE AND CREATION OF PARTNERSHIPS[1]

A partnership is an association of two or more people engaged as co-owners in a trade or business for profit.[2] This includes "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."[3] A partner is "a member in such a syndicate, group, pool, joint venture, or organization."[4]

Partners can contribute money, property, labor, or skill to the partnership in return for a share of the profit and loss of the partnership's business activity.

Partnerships do **not** pay federal income tax but instead "pass through" profits and losses to their partners who are liable for any income taxes resulting from the partnership's operations. The tax rules applicable to partnerships are sometimes referred to as **aggregate theory** or **entity theory.**[5]

The **aggregate theory** treats the umbrella entity as a collective sole proprietorship where each partner reports their share of the collective income and expenses on their personal return, as if each of them had individually earned the income or made the expenditures.

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 (i.e., whether to expense under IRC §179) must be made at the partnership level.

Although a partnership does not pay federal income tax for the reasons described, it is nevertheless responsible for filing an annual information return to report the income, deductions, gains, losses, etc., from its operations (Form 1065, *U.S. Return of Partnership Income*). This return includes Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* providing each partner with their share of these items for inclusion on their personal tax returns.

> **Note.** Unlike shareholders of S corporations, partners are **not** employees of the partnership and should **not** be issued a Form W-2, *Wage and Tax Statement,* by the partnership.

Notwithstanding the general rule that partnership taxation occurs at the partner level, the recently introduced centralized partnership audit regime (CPAR) procedures[6] switch from partner to **partnership** level the assessment and collection of any understatement of tax, interest, and penalties arising from an IRS audit conducted using these procedures. The Other Issues section later in this chapter discusses CPAR further.

Because each partner must report their share of all partnership items and because the partnership's internal operation is determined internally based on 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 partners from using their agreement to create allocations that are based on tax avoidance or a desire to shift future tax liabilities among partners. This is the purpose, for example, of the requirement that special allocations to certain partners have substantial economic effect (discussed later).[7]

1. IRS Pub. 541, *Partnerships; Tax Information for Partnerships*, Dec. 7, 2021. IRS. [www.irs.gov/businesses/partnerships] Accessed on Sep. 9, 2022.
2. *Uniform Partnership Act (1997) (Last Amended 2013), §102*. [www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=9e30c4d7-dbed-c173-dfc1-26394e60152d&forceDialog=0] Accessed on Feb. 23, 2022.
3. IRC §§761(a) and 7701(a)(2).
4. Ibid.
5. See e.g., *Holiday Village Shopping Center, Inc. v. U.S.*, 773 F.2d 276 (Fed. Cir. 1985).
6. See *Bipartisan Budget Act of 2015,* PL 114-74, §1101; IRS Pub. 5388, *Bipartisan Budget Act (BBA) Roadmap for Taxpayers*.
7. Treas. Reg. §1.704-1(b)(2).

Because of the lack of a precise definition of partnerships (beyond that provided by IRC §761(a)) and the sometimes informal nature of a business collaboration, the determination of whether an arrangement is a partnership may require a facts-and-circumstances analysis.

The Treasury's 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.[8] This is true even if a separate legal entity has not been created. Additionally, courts have considered the following facts and circumstances, none of which are conclusive.[9]

- 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
- 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. As one court stated, "the sharing of profits is a necessary, but not sufficient, condition for a finding that a joint venture exists."[10] 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.**

TYPES OF PARTNERSHIPS[11]

A partnership arrangement results in two sets of relationships.

1. The relationship of the persons to each other within their common activity[12]
2. The relationship of the activity to the rest of the world[13]

Many partnership arrangements prefer a limited liability company (LLC) entity structure where each member of the LLC is responsible for their own actions and there are no members with unlimited liability exposure (LLCs are further discussed later).

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8. Treas. Reg. §301.7701-1(a)(2).
9. *Luna v. Comm'r*, 42 TC 1067 (1964).
10. *ACME Music Company, Inc. v. IRS*, 196 BR 925 (BR WD Pa 1996).
11. See IRC §761.
12. For federal income tax purposes, rules regarding the relationship of the persons to each other within their common activity are contained in subchapter K of the Code. The determination that an entity is a partnership for income tax purposes is made under federal tax law.
13. The rules that determine the relationship of the activity to the rest of the world are generally governed by state law.

Generally, an unincorporated organization with two or more members that divides its profits from a trade, business, financial operation, or other venture is classified as a partnership for federal tax purposes. By contrast, a joint undertaking just to share expenses is not necessarily a partnership.

Example 1. Anne and Mary are co-owners of a warehouse, which they rent to Brad, who is responsible for all the repairs and maintenance under the rental contract. Because Anne and Mary do not provide any services to Brad, this rental activity does not need to be treated as a partnership. Instead, Anne and Mary can each report their 50% share of rental income and expenses on their personal tax returns using Schedule E, *Supplemental Income and Loss*.

Organizations with at least two members that have not elected corporate treatment can be classified as partnerships **unless** they belong to the following list of **excluded** organizations.[14]

- An organization formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association
- An insurance company
- Certain banks
- An organization wholly owned by a state, local, or foreign government
- An organization specifically required to be taxed as a corporation by the Code (for example, certain publicly traded partnerships (PTP))
- Certain foreign organizations identified in Treas. Reg. §301.7701-2(b)(8)
- A tax-exempt organization under IRC §501(a)
- A real estate investment trust
- An organization classified as a trust under Treas. Reg. §301.7701-4 or otherwise subject to special treatment under the Code

Business Entities Electing Corporate Classification

Business entities that are not on the preceding list of excluded organizations can elect to be classified as a corporation. This is usually done by filing Form 8832, *Entity Classification Election*.

Observation. Tax practitioners will typically see LLCs file Form 8832.

Generally, the effective date of an entity classification election cannot be more than 75 days prior to or later than 12 months after the date the election is filed. Late election relief is available in certain circumstances.[15]

Small business corporations wishing to elect Subchapter S (pass-through) status can do so using Form 2553, *Election by a Small Business Corporation*.[16]

Note. For more information on the nature of an S corporation and the S corporation election, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: S Corporation Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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14. Treas. Regs. §§301.7701-2(c) and 301.7701-3; IRS Pub. 541, *Partnerships; Tax Information for Partnerships*, Dec. 7, 2021. IRS. [www.irs.gov/businesses/partnerships] Accessed on Sep. 9, 2022.

15. See instructions for Form 8832 for more information on late election relief.

16. See instructions for Form 2553 for more information.

LLC. An LLC is an entity formed under **state** law. One of the legal distinctions between an LLC and other eligible entities is that LLC members are generally **not** personally liable for the LLC's debts.[17]

For federal tax purposes, an LLC may be classified as:[18]

- A partnership,
- A corporation, or
- An entity disregarded as separate from its owner.

A single-member LLC is treated as a disregarded entity absent an election to be treated as a corporation.[19] Depending upon the nature of the LLC's activities, the disregarded entity's tax reporting is made on one of the following schedules attached to a Form 1040, *U.S. Individual Income Tax Return*, or Form 1040-SR, *U.S. Tax Return for Seniors.*

- Schedule C, *Profit or Loss from Business (Sole Proprietorship)*
- Schedule E, *Supplemental Income and Loss*
- Schedule F, *Profit or Loss from Farming*

Default Rules[20]

There are entity classification "default rules" also known as "check the box" rules that apply to eligible organizations that do not elect corporate status. These rules differ depending upon whether the entity is **domestic** or **foreign.**

Domestic Default Rule. Under this rule, a **domestic** eligible entity is:

- A partnership if it has two or more members; or
- Disregarded as an entity separate from its owner if it has a single owner.

Foreign Default Rule. A **foreign** eligible entity is:

- A partnership if it has two or more members and at least one member does not have limited liability;
- A corporation if all members have limited liability; or
- A disregarded entity if it has a single owner that does not have limited liability.

> **Note.** Detailed requirements regarding the classification of foreign eligible entities are beyond the scope of this chapter.

17. See IRS Pubs. 15, *Employer's Tax Guide (Circular E)*, and 3402, *Taxation of Limited Liability Companies*.
18. Treas. Reg. §301.7701-3.
19. *Single Member Limited Liability Companies*. Sep. 1, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies] Accessed on Mar. 4, 2022.
20. Treas. Reg. §301.7701-3(b); *Overview of Entity Classification Regulations (a/k/a Check-the-Box)*. Sep. 24, 2017. IRS. [www.irs.gov/pub/int_practice_units/ore_c_19_02_01.pdf] Accessed on Feb. 23, 2022.

PTP[21]

A PTP is treated as a corporation **unless** at least 90% of the partnership's income is qualifying income derived from **passive** sources (e.g., interest, dividends, real property rents and gains, etc.).

For this purpose, a PTP is any partnership where interests in that partnership are traded:

- On an established securities market, or
- Are readily tradable on a secondary market.

Spousal Joint Ventures

A joint venture whose owners are married to each other and who share in its profits and losses, may be classified as a partnership regardless of whether there is a formal partnership agreement (discussed later).

To avoid this result, married co-owners filing a joint return, can make a qualified joint venture (QJV) election to **not** treat the joint venture as a partnership for federal tax purposes if:[22]

1. They both materially participate in the trade or business,[23] and
2. **The business is not held in the name of a state law entity such as a limited partnership or LLC.**

Accordingly, each spouse is treated as a sole proprietor reporting their share of business income, gain, losses, deductions, and credits on Schedule C (Form 1040).

Making the QJV Election.[24] Spouses make this election by reporting their respective interest in the trade or business on Schedules C, E, or F as appropriate. The previous partnership classification of the trade or business terminates at the end of the tax year immediately preceding the year the QJV election takes effect.

> **Note.** The corresponding QJV box in part I should be checked when the QJV is reported on Schedule E. For more information on making the QJV election, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Schedule E. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Once made, the QJV election remains in effect for future years unless:

- It is revoked with permission from the IRS, or
- The spouses no longer meet the requirements for a QJV.

Employer Identification Number (EIN).[25] Spouses with a QJV election **are not required** to have an EIN unless the business is required to file excise, employment, alcohol, tobacco, or firearms returns. When required, **each spouse** should complete a Form SS-4, *Application for Employer Identification Number*, and request an EIN as a sole proprietor.

If the business previously filed as a partnership, the partnership EIN cannot be used by either spouse in the QJV. However, if the business reverts to being a partnership, then the partnership EIN applies once more.

When a business has employees, either of the sole proprietor spouses may fulfill employment tax reporting requirements using their sole proprietorship EIN.

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21. IRC §7704 and Treas. Reg. §1.7704-1.
22. IRC §761(f).
23. See IRC §469(h) and the instructions for Form 1065 for a definition of material participation.
24. *Election for Married Couples Unincorporated Businesses*. Dec. 3, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/election-for-married-couples-unincorporated-businesses] Accessed on Mar. 8, 2022.
25. Ibid.

Example 2. Sam and Pam are married to each other and file jointly. They materially participate as co-owners of Spam Creations (not a state law entity) in which Pam and Sam have divided the ownership 60/40. The business operates a retail outlet with two employees. Until 2020, Spam Creations reported as a partnership. In 2021, Pam and Sam conduct their business as sole proprietors maintaining their existing ownership shares with Sam assuming employment tax reporting responsibility.

For 2021, Sam and Pam make a QJV election for their business. Consequently, each spouse reports on Schedule C their respective share of the business's income, gain, losses, deductions, and credits for 2021. However, only Sam is required to make 2021 employment tax returns for the business's employees. Therefore, only Sam is required to obtain an EIN to satisfy this reporting requirement.

Note. Generally, if spouses have formed an LLC, they are excluded from making a QJV election and must report on a partnership return. The exception is spouses residing in a community property state whose joint ownership of an LLC is community property. Such spouses may choose to treat the LLC either as a disregarded entity or as a partnership (and file partnership returns).[26]

PARTNERSHIP AGREEMENT[27]

Typically, partners prefer to have a partnership agreement which is a legally binding document stipulating how the partnership will operate. If the partners do not have an agreement, then operation of the partnership as well as dispute resolution between the partners will be governed by state law.

Usually this agreement includes the following.

- Business name and description
- Business and owner contact information
- Responsibilities of each partner in the business
- Each partner's ownership share of the business
- Each partner's profit and loss share

In addition, the agreement could address issues like the management of the business, as well as how to handle the death or exit of a partner and inclusion of new partners.

Note. Which expenses are reimbursable by the partnership is not typically included in a partnership agreement, however this is a critical piece of information in order to protect the deductibility of unreimbursed partnership expenses by individual partners.

Note. Although partnership agreements are typically written, oral partnership agreements are also possible.

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26. Rev. Proc. 2002-69, 2002-2 CB 831.

27. *Partnership Agreement: What Is It? And Do You Need One?* Miranda, Dana; Haskins, Jane; and Watts, Rob. Aug. 18, 2021. Forbes. [www.forbes.com/advisor/business/partnership-agreement] Accessed on Mar. 8, 2022; Treas. Reg. §1.761-1(c).

Fundamentally, the partnership agreement serves to record the partners' mutual understandings to aid in resolving any subsequent disagreements.

Note. A partnership agreement is not a requirement in forming a partnership. However, a partnership that does **not** have a partnership agreement will be subject to state law regarding the operation of the partnership. This could lead to results that conflict with the partners' intentions which could have been avoided if a partnership agreement had been in place.

The Code stipulates that a partnership agreement includes the original agreement plus any modifications. Modifications to the agreement must be agreed to by all partners or adopted in any other manner provided by the partnership agreement.[28]

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the partnership return due date (not including extensions).[29]

Matters not addressed in the partnership agreement may be addressed in applicable provisions of local (state) law. Under state law, the statutory rules governing the internal relationships of the partners to each other are default rules which apply in the absence of a partnership agreement or where the partnership agreement is silent.[30]

Practitioner Planning Tip

Tax practitioners are advised to obtain a copy of the partnership agreement before preparing any partnership returns. Because a partnership agreement is a legal matter, clients needing help in drafting a partnership agreement should seek help from an attorney.

PARTNERSHIP OR MULTI-MEMBER LLC

There are various types of legally constituted partnerships. Broadly speaking, they can be separated into two distinct classes: **partnerships** or **multi-member LLCs (MMLLC).** However, as discussed next, there are various admissible legal structures within each of these two classes. Choosing an appropriate legal structure often depends on the type of activity the trade or business is engaged in and the legal objectives of the parties.

Partnership[31]

There are various possible partnership legal structures.

General Partnership (GP). An **advantage** of a GP is that it is easy to create. Generally, no state filing is required, and the GP does not pay a formation filing fee, ongoing state fees, or franchise taxes. It may nevertheless be required to obtain business licenses and permits needed to operate.

28. IRC §761(c).

29. Ibid.

30. Treas. Reg. §1.761-1(c).

31. *Comparing 3 Types of Partnerships in Business*. Nelson, Nikki. Aug. 4, 2020. Wolters Kluwer. [www.wolterskluwer.com/en/expert-insights/compare-types-of-partnerships-lp-llp-gp] Accessed on Mar. 21, 2022.

The main **disadvantage** of a GP is that the owners have no liability protection. Each partner's personal assets may be accessible to creditors of the business. Furthermore, each partner is responsible for the business actions of the other partners.

Example 3. David has a 70% ownership share, and John a 30% ownership share of Florida Landscaping GP. The business leases $30,000 of equipment from Lawnmowers, Inc. for use in its operations. After several months, David files for bankruptcy and the partnership fails to make the monthly lease payments.

Because Florida Landscaping is a GP, Lawnmowers, Inc. can hold John or David liable for the entire amount of the missed payments.

Limited Partnership (LP). The key distinction between an LP and a GP is that an LP has two types of partners: **general** partners and **limited** partners. At least one partner in the LP must be a general partner and like the GP, general partners have responsibility for operations of the partnership and unlimited financial liability. In practice, the general partner is often a corporation thereby providing limited liability protection to the shareholders and potentially avoiding the liability issues created as a general partner. By contrast, a limited partner's liability is limited to their investment in the partnership (i.e., creditors of the partnership cannot seize personal assets of limited partners). Furthermore, limited partners are generally not involved in day-to-day operations of the partnership.

Caution. A limited partner may become personally liable if they assume an active role in a business, taking on the duties of a general partner.[32]

LPs are often used for short-term projects or ventures (e.g., film production, family estate planning, etc.).

Example 4. Use the same facts as in **Example 3,** but Florida Landscaping is an LP and John is a limited partner. Lawnmowers, Inc. only has recourse to the assets of Florida Landscaping or to the general partner, David, for the unpaid debt. Therefore, John's financial liability is limited to his investment in Florida Landscaping LP.

Limited Liability Partnership (LLP). An LLP structure is created under state law and applies to certain professional service businesses (e.g., accountants, attorneys, architects, dentists, doctors, etc.). Like a limited partner in an LP, creditors cannot pursue the personal assets of LLP partners to satisfy financial obligations of the LLP resulting from the acts of their partners. Nevertheless, LLP partners assume liability for their own personal acts.

Limited Liability Limited Partnership (LLLP).[33] Certain states permit the formation of LLLPs. The key difference between an LLP and an LLLP is that the liability of a general partner in an LLLP is limited. They are not used much because LLCs (discussed later) are often preferred.

MMLLCs[34]

Except for the LLLP, a disadvantage of other partnership legal structures is the unlimited financial liability of general partners. Because **all** members of an LLC have limited liability (as previously discussed), LLCs have become popular alternatives to other partnership structures.

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32. Treas. Reg. §1.469-5.

33. *What is an LLLP? Limited Liability Limited Partnerships Explained*. Zoellner, Carl. Jul. 29, 2020. Anderson Legal, Business & Tax Advisors. [andersonadvisors.com/lllp-limited-liability-limited-partnership] Accessed on Mar. 21, 2022; *What Is a Limited Liability Limited Partnership (LLLP)?* Dec. 3, 2015. Carnahan Evans. [carnahanevans.com/limited-liability-limited-partnership-lllp] Accessed on Mar. 21, 2022.

34. *What are the Different Types of LLC: Everything You Need to Know*. 2022. upcounsel. [www.upcounsel.com/what-are-the-different-types-of-llc] Accessed on Mar. 21, 2022; *Types of Limited Liability Companies*. 2022. Nolo. [www.lawfirms.com/resources/business/business-operations/types-limited-liability-companies.htm] Accessed on Mar. 21, 2022.

When investors form an LLC, they can either choose a member- or manager-managed structure, whereby the company is run by the members in the former case or by an appointed manager in the latter case. For member-managed LLCs, every member has authority to act on the behalf of the company. A manager-managed structure is used when the LLC has passive members interested only in the investment.

LLCs are formed and operated under state statutes. There are many possible LLC legal structures in which partnership entity classification can apply, though some are available only in certain states. A brief description of some of these structures follows.

Anonymous LLC. As the name suggests, a key purpose of anonymous LLCs is to restrict public access to ownership details. Presently, only New Mexico permits the establishment of a completely anonymous LLC.

Low-Profit LLC (L3C). An L3C is a for-profit alternative to a not-for-profit institution. This option caters to institutions formed for a philanthropic purpose that prefer the tax treatment of an LLC.

Non-Profit LLC (NPLLC). While most partnerships are for-profit activities, some states permit the formation of an NPLLC, which has tax-exempt status like a non-profit corporation while enjoying limited liability protection similar to a for-profit LLC.

Professional LLC (PLLC). A PLLC is an LLC option for the provision of certain professional services (e.g., medical, legal, etc.). Taxpayers interested in forming a PLLC should review applicable state laws.

Restricted LLC. A restricted LLC is currently only possible in Nevada (since 2009). Under the articles of organization of a restricted LLC, its members must wait 10 years from company formation before they can receive business distributions.

Series LLC (SLLC).[35] Since 1996, investors have had the opportunity to form a series LLC consisting of a master LLC acting as a parent for multiple protected series. Thus, each protected series has a brother-sister relationship to every other protected series, and creditors of one protected series cannot pursue assets of another brother-sister protected series. Another key benefit of the SLLC is that only one set of filing fees is required to form the master LLC. However, additional fees may be required for each additional series.

The same members of the master LLC may or may not also be members of each protected series (to avoid member conflicts). Once formed, the master LLC can designate an unlimited number of protected series. A common example of an SLLC consists of a master LLC that holds no assets and conducts no activities. The master LLC then designates a Management Series to oversee operations of the business and other protected series to hold assets or operate different parts of the business.

Practitioner Planning Tip

Tax practitioners should be aware that each SLLC files its own tax return absent a consolidated election.

35. *The Series LLC: An organizational structure that can help mitigate risk*. Feldman, Sandra. Feb. 18, 2020. Wolters Kluwer. [www.wolterskluwer.com/en/expert-insights/the-series-llc-an-organizational-structure-that-can-help-mitigate-risk] Accessed on Mar. 30, 2022; *How To Structure a Series LLC*. Inc now. 2022. [www.incnow.com/delaware-series-llc/series-llc-structure] Accessed on Mar. 30, 2022.

Example 5. Jack and Jill, a married couple, own JJ Holdings, LLC which in turn owns two business activities: Jack's Books and Jill's Music. If Jack's Books is unable to meet its financial obligations, its creditors can pursue the assets of Jill's Music. To avoid this situation, Jack and Jill form JJ Holdings Series LLC and designate two protected series, one for each of their business activities. Now, the creditors of one of their businesses cannot pursue the assets of the other business.

Jack and Jill could have obtained a similar result by instead forming two separate LLCs – one for each business. However, Jack and Jill save on state franchise taxes and registered agent's fees if they have one SLLC rather than two traditional LLCs.

Currently 20 states permit formation of SLLCs.[36] Specific information regarding the formation of an SLLC in Illinois is available from the Illinois Secretary of State.[37]

Practitioner Planning Tip

Tax practitioners are advised to obtain a copy of the LLC operating agreement before preparing any LLC returns. Because an LLC operating agreement is a legal matter, clients needing help in drafting an LLC operating agreement should seek help from an attorney.

CO-TENANCIES[38]

A co-tenancy is "the simultaneous title or interest of more than one person in the same property."[39] However, such co-ownership of property or cost-sharing arrangements does not necessarily create an entity for classification purposes. For example, an undertaking by property owners to share the expenses of constructing a ditch to drain surface water from their properties does not create a separate entity for federal tax purposes. The same is true for a simple lease of farm property to a farmer for a cash rental or a share of the crops, even if there are multiple owners of the farm property.

Even though the arrangement does **not** create an entity for classification purposes, the co-tenant owners could elect to file partnership returns. Once a return is filed, it would be difficult for any of the co-tenants to deny the existence of a partnership. This can create various disadvantages for any co-tenant such as preventing them from individually electing a like-kind exchange (LKE) on a disposition of the property.[40] This is further explained later in this chapter.

36. Ibid. These states are Alabama, Arkansas, Delaware, District of Columbia, Illinois, Indiana, Iowa, Kansas, Missouri, Montana, Nebraska, Nevada, North Dakota, Oklahoma, Puerto Rico, Tennessee, Texas, Utah, Virginia, and Wyoming.

37. *A Guide for Organizing Domestic Limited Liability Companies*. White, Jesse. Feb. 2020. Illinois Secretary of State. [www.ilsos.gov/publications/pdf_publications/c334.pdf] Accessed on Jun. 27, 2022.

38. Treas. Reg. §301.7701-1(a)(2).

39. *Cotenancy*. Jun. 2021. Legal Information Institute. [www.law.cornell.edu/wex/cotenancy] Accessed on Apr. 18, 2022.

40. Ltr. Rul. 9741017 (Jul. 10, 1997).

Practitioner Planning Tip

Taxpayers may have established a co-tenancy so that they are not required to file partnership tax returns. However, if the IRS later determines that a partnership exists, the partnership could be subject to substantial penalties for failure to file returns. Further, if the taxpayers actually sell and exchange property expecting LKE treatment, a partnership determination post-transaction could carry a substantial tax cost. Consequently, the practitioner should review the nature of the relationship between the co-tenants and review the services to be provided to assist in determining whether a partnership exists. If there is enough at stake, the practitioner may advise that the taxpayers seek a private letter ruling. Also, the practitioner may want to determine if an election out of Subchapter K (discussed later) would be appropriate.

Example 6. Don and Pearl Strong lived on and worked a 640-acre wheat farm in western Kansas for more than 50 years. Pearl passed away in 2010. Don continued to live on and work the farm until his death in 2014. Don and Pearl had four children — Frank, Opal, Ruby, and Crystal. Frank lives close by and has worked the farm with his parents since he was a child. The girls all moved away to Topeka, Dallas, and Denver, respectively, and have let Frank manage things back home.

When Don died, Frank took Don's death certificate and will to the county clerk and transferred the property into joint tenancy with rights of survivorship for the four children. Since Don's death, Frank has sent letters each year to each of his sisters in January which "reported" the sisters' shares of the farm operation income and expenses, so they (like he) could complete their respective income tax returns for the prior year.

In 2022, Frank suffered a stroke and is unable to manage the farm now or in the future. A neighboring farmer approaches Frank, offering $13,000 an acre for the farm land. The value at Don's death was $5,000 an acre. The $5,120,000 gain ($8,000 gain per acre × 640 acres) is allocated a quarter apiece to the four children, who happen to be in very diverse financial circumstances. Due to high medical bills, Frank would like cash now. Opal is married to a high-powered personal injury attorney and would like to postpone any tax as long as possible. Ruby just got divorced and would like to have monthly payments. Crystal does not seem to care about the money, as she is a novice at a convent.

Observations:

- The IRS may be able to successfully argue that a partnership has existed since Don died and the property was transferred into joint ownership with rights of survivorship. Under the provisions of Rev. Proc. 2002-22, there is no requirement that a formal entity exist. Additionally, Treas. Reg. §301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits accordingly.
- The siblings may argue that there is not a trade or business being carried on and rather there is a mere sharing of expenses on the property,
- There is enough tax involved for the siblings to consider pursuing a private letter ruling.
- The siblings may determine that a partnership did exist and determine whether an election out of Subchapter K is available.

The provision of services by or on behalf of the co-owners may result in a partnership for federal tax purposes (i.e., where co-owners of an apartment building lease space and provide services to the occupants either directly or through an agent). The government considers whether:

1. Services are provided to tenants independently of the apartment rentals, and
2. The co-owners receive income from the provision of those services.

In a 1975 Revenue Ruling, the IRS considered the case of co-owners of apartment units who provided services to the tenants of their apartments through a third-party manager (including attendant parking, cabanas, gas, electricity, and other utilities). Because these services were provided by and billed by the manager independently, the manager's activities were found not to be sufficiently extensive to cause partnership classification of the co-ownership.[41]

Effect of Holding Real Estate in an LLC[42]

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.

> **Note.** Where title of the real property is held by a MMLLC, the IRS will treat the activity as a **partnership** requiring the filing of a partnership return.

Co-Tenancy Tax Reporting[43]

For a co-tenancy that is **not** classified as a partnership, it is the responsibility of the individual co-owners to report their proportionate share of income and expenses on Schedule E of their respective individual returns. However, if the co-owners also provide substantial services that are primarily for their tenant's convenience, then each co-owner should report income and expenses on Schedule C.

> **Note.** The IRS does not provide guidance on what constitutes "significant services." As such, a facts and circumstances approach should be used in determining whether the services rise to the level of substantial and should be reported on Schedule C.

PARTNERSHIP VS. CORPORATION[44]

As previously stated, the determination that an entity is a partnership for income tax purposes is made under federal tax law, which may be broader than comparable state law. Certain organizations can elect corporate rather than partnership classification.

In contrast to a partnership, a **C corporation** is a separate **tax-paying** entity that conducts business, realizes net income or loss, pays taxes, and distributes profits to shareholders. The corporation is currently subject to corporate tax (at 21%) on its profits when earned, as well as other taxes (e.g., accumulated earnings tax). Corporate shareholders are then taxed again when they receive those profits in the form of dividends. Furthermore, shareholders cannot personally deduct any losses of the corporation.

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41. Rev. Rul. 75-374, 1975-2 CB 261.
42. See Rev. Proc. 2002-22, 2002-1 CB 733 (§6.01).
43. *Topic No. 414 Rental Income and Expenses*. Feb. 17, 2022. IRS. [www.irs.gov/taxtopics/tc414] Accessed on Apr. 18, 2022.
44. IRS Pub. 542, *Corporations; Forming a Corporation,* Jun. 23, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/forming-a-corporation] Accessed on Sep. 9, 2022.

Many corporations can elect **S corporation** treatment. The corporation **must** meet all the following requirements to qualify for an S corporation election.[45]

- Be a domestic corporation
- Have only allowable shareholders (including individuals, certain trusts, and estates but **not** partnerships, corporations, or non-resident alien shareholders)
- Have no more than 100 shareholders
- Have only one class of stock
- Not be an ineligible corporation (e.g., certain financial institutions, insurance companies, and domestic international sales corporations)

Generally, S corporations are treated as pass-through entities (PTEs) like partnerships except that certain income and gains are taxed at entity level (i.e., certain passive income and built-in gains if the S corporation was previously a C corporation). Another contrast with partnerships is that S corporations "must pay reasonable compensation to a shareholder-employee in return for services that the employee provides to the corporation before non-wage distributions may be made to the shareholder-employee."[46] This reasonable compensation paid to the shareholder-employee is reported by the S corporation on Form W-2.

Note. For more information on C corporations and S corporations, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: C Corporations and 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: S Corporation Issues. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Determining which of these classifications is preferable requires weighing multiple factors including both tax and legal issues. The following table provides an overview of some of the advantages and disadvantages of each entity classification.

Factor	Partnership or MMLLC	S Corporation	C Corporation
PTE	Yes	Yes (Generally)	No
Double taxation of profits	No	No (Generally)	Yes
Over 100 co-owners	Yes	No	Yes
Entity loss deduction by owners	Yes	Yes	No
Multiple stock classes	No	No	Yes
Co-owner limited liability	Yes (Generally) [a]	Yes	Yes
Easy co-owner exit	Yes	No	No

[a] Except for general partners.

45. *S Corporations*. Jan. 18, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporations] Accessed on Apr. 18, 2022.

46. *S Corporation Compensation and Medical Insurance Issues*. Apr. 29, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues] Accessed on Apr. 18, 2022.

Practitioner Planning Tip

Regarding multiple stock classes, although a partnership does not have stock, there can be differences among partners as part of the partnership agreement — for example, there could be a preferred equity interest.

A partner exiting a partnership can incur no tax depending on basis whereas C corporations and even S corporation shareholder distributions can result in a taxable gain to the corporation (based on the difference between the distributed property's fair market value (FMV) and its adjusted basis).[47]

The preceding table is only intended to be a broad guide. Tax practitioners should weigh all pertinent factors before advising their clients on an appropriate entity classification and encourage their clients to seek legal counsel as appropriate.

ELECTING OUT OF SUBCHAPTER K[48]

Partnership taxation is governed by subchapter K (IRC §§701–777) which contains some of the most complex provisions in the Code. Under the default entity classification rules discussed earlier, a **domestic eligible entity** is classified as a partnership if it has two or more members.[49] However, §761(a) authorizes the IRS to permit members of an unincorporated organization to **elect out** of all or part of subchapter K. The benefits of making a §761 election are covered later in this section.

Note. A §761(a) election must be made by **all** the members of the unincorporated organization. The election is made by attaching a statement to the partnership return for the first year that the members are requesting to opt out of subchapter K.[50] Electing out of subchapter K eliminates some of the tedious paperwork that comes with being classified as a partnership.

ELIGIBLE ORGANIZATIONS

To elect out of subchapter K, it must be possible to adequately determine income of the organization's members **without** needing to compute partnership taxable income. Besides meeting this stipulation, an entity eligible to make the §761(a) election is an unincorporated organization that was formed:

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

Note. In practice, practitioners should consider a §761(a) election for unincorporated organizations engaged in investment activities or securities dealers. The second category is principally for public utilities.

47. IRC §311.
48. IRC §761(a) and the Treasury Regulations thereunder.
49. Treas. Reg. §301.7701-3(b).
50. See IRC §761(a); Treas. Regs. §§1.761-1 and 1.761-2(b).

Investment Partnerships[51]

Treasury regulations contain specific requirements that an investment partnership must meet to make a §761(a) election. These requirements are as follows.

- The participants must be involved in the joint purchase, retention, sale, or exchange of investment property.
- They must own the property as co-owners.
- Each participant must reserve the separate right to take or dispose of their shares of any property acquired or retained.
- The participants must **not** actively conduct business or irrevocably authorize some person(s) 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.

Caution. Unfortunately, from the standpoint of the §761(a) election, many state statutes treat the LLC, rather than its members, as the **owner** of LLC property and prohibit members from demanding property distributions.[52] Consequently, the §761(a) election is **not** available to LLCs whose members are not treated as co-owners of LLC property under the relevant state statute.

Investment Clubs.[53] As previously stated, a §761(a) election cannot be made by an organization engaged in the **active conduct of a trade or business.** In fact, in a 2001 private letter ruling the IRS concluded that "most stock investment clubs are not eligible to make the election out of the application of subchapter K. Instead, such organizations are treated as partnerships, and all of the rules under §701 through §761 apply to them."

Note. In reaching this conclusion, the IRS referred to §761(a) and the regulations thereunder. While it did not specifically refer to the active conduct of a business, it is likely that this was the primary motivating factor for the decision.

Rental Real Estate Partnerships. A rental real estate partnership must overcome the following two hurdles for a successful §761(a) election out of subchapter K.

1. Co-ownership of the property by the participants in the venture
2. The right of each participant to take or dispose separately of their share of the property

As stated earlier, property titled in the name of an entity is not considered co-owned directly by the participants in the venture. Instead, they are considered to each own an interest in the entity.

A couple of IRS pronouncements help to clarify what is meant by "own the property as co-owners" as used in the Treasury Regulation in the context of an investing partnership.[54]

The first of those pronouncements is of particular concern for limited partners of an LP.[55] Here the IRS concluded that the partners in an LP that was formed to finance a new aircraft were not co-owners of the partnership property and generally could not take or dispose of their shares of the property at will. This was despite the existence of a statement in the partnership agreement that the partnership was intended to be an investment partnership.

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51. Treas. Reg. §1.761-2(a)(2).
52. *Identifying and Making LLC Elections*. Ellentuck, Albert B., Jun. 1, 2013. The Tax Adviser. [www.thetaxadviser.com/issues/2013/jun/casestudy-jun2013.html] Accessed on Apr. 19, 2022.
53. Ltr. Rul. 2001-0279 (Dec. 31, 2001).
54. Treas. Reg. §1.761-2(a)(2)(i).
55. FSA 200216005 (Jan. 10, 2002).

In a private letter ruling, the IRS ruled that the investors in a rental real estate partnership could not make a §761(a) election because the co-owners of the property did not separately reserve their right to take or dispose of their shares of any property acquired or retained.[56]

In reaching this conclusion, the IRS noted that the investors entered into an agreement with a third-party agent to act for them in selling or otherwise disposing of the venture's property. As part of this agreement, the investors surrendered their rights to take and separately sell their respective shares of the property. Consequently, the joint venture was more than mere co-ownership of property and was properly classified as a partnership.

EFFECT OF ELECTING OUT OF SUBCHAPTER K[57]

Earlier it was noted that §761(a) authorizes the IRS to permit members of an unincorporated organization to elect out of **all** or **part** of subchapter K. Consequently, even after a successful §761(a) election, **parts** of subchapter K may continue to apply. For example:

- Partners cannot deduct losses that exceed their basis in the partnership,[58] and
- A business purpose is required to adopt a tax year for the partnership different from that of its principal partners.[59]

An organization making a successful §761(a) election should also consider that such election does not extend to sections of the code beyond subchapter K. This is the IRS's position, and it has been upheld by the courts. For example, the Tax Court stated in *Bryant v. Comm'r*:[60]

> *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.*

So, for example, a participant in an organization that has made a §761(a) election is not treated as having sold a partnership interest (which would be considered the sale of a capital asset under subchapter K).[61] Additionally, the sale is also **not** subject to ordinary income recharacterization for certain items, such as cash-basis receivables.[62] 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.[63]

Also, the existence of a successful §761(a) election does not necessarily imply that a partnership does not exist for sections of the Code other than subchapter K even though income and deductions are now computed at the partner rather than the partnership level. The IRS addresses this conundrum by asking whether the other Code provisions and the provisions of subchapter K are "interdependent" (i.e., dependent upon each other). Where interdependency exists, the organization is treated as a partnership. Otherwise, each partner is treated as directly owning an interest in the assets. This position is encapsulated in a General Counsel Memorandum stating that:[64]

> *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.*

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56. Ltr. Rul. 8002111 (Oct. 22, 1979).
57. *Electing Out of Subchapter K Under IRC § 761(a): Can Certain Limited Liability Companies and Limited Partnerships Become Eligible to Make the Election?* Nelson Jr., John. C, Jan. 21, 2022. SSRN. [papers.ssrn.com/sol3/papers.cfm?abstract_id=4014620] Accessed on Apr. 20, 2022; Banoff, Sheldon I. (2004). Will IRS Reconsider Elections Out of Subchapter K by Partnerships and LLCs?, *Journal of Taxation* 101, 188 – 189.
58. See IRC §704(d) and Rev. Rul. 58-465, 1958-2 CB 376.
59. See IRC §706(b) and Rev. Rul. 57-215, 1957-1 CB 208.
60. *Bryant v. Comm'r*, 46 TC 848 (1966), *aff'd* 399 F.2d 800 (5th Cir. 1968).
61. IRC §§741 and 1221.
62. IRC §751.
63. TAM 9214011 (Dec. 26, 1991) and IRC §1231.
64. GCM 39043 (Oct. 5, 1983).

An example of **non-interdependency** is the nonrecognition of gain or loss rules on the exchange of real property held for productive use or investment.[65]

Generally, these **LKE** rules do not apply to "any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships."[66]

So, for a non-electing partnership to utilize these **LKE** rules the partnership must conduct the exchange of its real property.

However, if the partnership can make a §761(a) election, then the individual partners are considered to own a share of each of the assets of such partnership as addressed by IRC §1031(a)(2) which states 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.*

For purposes of ownership of the partnership's assets, this means that the partners and partnership are no longer interdependent because the property is **now** co-owned by the partners.

Now the question arises as to whether a partner with a fractional share of real property (commonly referred to as a tenancy in common interest) can utilize the LKE rules. Pursuant to Rev. Proc. 2002-22, tenancy in common interests that can qualify as co-ownership interests must satisfy the following conditions.[67]

- The maximum number of tenants in common permitted is 35.
- The sponsor or organizer of the interests may own the property (or an interest therein) for only six months before selling 100% of the units.
- Unanimous decisions are required on anything of material or economic impact to the property or its owners.
- The management agreement (if applicable) must be at a market rate and renewable annually.

Practitioner Planning Tip

Taxpayers with tenancy in common interests that meet Rev. Proc. 2002-22 conditions could now be of interest to buyers looking for property that meets the LKE replacement property requirements.

65. IRC §1031.

66. Treas. Reg. §1.1031(a)-1(a)(1).

67. *IRS Expands Replacement Property in 1031 Exchanges*. Raitz, Ronald L. and Hannah, Rob. Jul. 1, 2002. Journal of Accountancy. [www.journalofaccountancy.com/issues/2002/jul/irsexpandsreplacementpropertyin1031exchanges.html] Accessed on May 23, 2022.

The following are some examples of the impact on other (non-subchapter K) Code sections in the presence of a §761(a) election.

- In *Bryant v. Comm'r*[68] the Tax Court held that the investment tax credit is determined at the partnership rather than partner level for a partnership that elected out of subchapter K. Therefore, the individual partners of the partnership were each entitled to their share of the $50,000 investment tax credit limitation under §48(c)(2).[69]
- Partners must treat their distributive share of partnership business income as net earnings from self-employment.[70]
- Individual partners can separately elect to treat their share of mine development costs as currently deductible or as deferred expenses under IRC §616(b).[71]
- A partner is entitled to an IRC §165 abandonment loss when they abandon their proportionate interest in property of the partnership rather than when the partnership abandons the property.[72]

The following table shows some of the benefits and drawbacks of making a §761(a) election.

Advantages	Disadvantages
Although financial statements are required for investors to satisfy their personal tax reporting responsibilities, partnership tax returns are not required. This will likely result in tax compliance cost savings.	The IRC §721 nonrecognition of gain or loss rules on property contributions by the partners to the partnership no longer apply which could trigger gain recognition on such contributions.
Co-owner shares in property **may** qualify for §1031 tax-free treatment, but **not** partnership interests.	A §761(a) election not recognized by the IRS could result in adverse consequences if the partnership then fails to respect subchapter K.
The IRC §183 hobby loss provisions apply at the co-owner level rather than at entity level.	A failed §761(a) election could also result in penalties for failure to file partnership tax returns.[73]
Unlike partners in a partnership who are subject to IRC §703(b), co-owners can make separate depreciation and depletion method elections.	Certain partnership level elections are no longer available (e.g., IRC §754 optional adjustment to basis of partnership property).
Co-owners are treated as having a proportionate interest in each asset held by the organization. Thus, sales of these proportionate interests are subject to the IRC §1231 rules applying to property used in a trade or business rather than the IRC §1221 capital asset rules applying to the sale of a partnership interest.	A §761(a) election could result in the activity not qualifying for qualified business income deduction (QBID) under IRC §199A. The determination of whether there is an active trade or business is made by the co-owner rather than the entity.
State and local entity level taxes on partnerships **may** be avoided assuming the state respects the §761(a) election.	

Observation. Before advising a client to make this election, the practitioner should carefully weigh these advantages and disadvantages. Although, for a successful a §761(a) election, it is likely that the benefits will outweigh the drawbacks.

68. *Bryant v. Comm'r*, 46 TC 848 (1966), *aff'd* 399 F.2d 800 (5th Cir. 1968).
69. Now IRC §38(c)(1).
70. IRC §1402 and *Cokes v. Comm'r*, 91 TC 222 (1988).
71. Rev. Rul. 83-129, 1983-2 CB 105.
72. TAM 9214011 (Dec. 26, 1991).
73. IRC §6698.

ELECTING EXCLUSION FROM SUBCHAPTER K[74]

As previously mentioned, unincorporated organizations can fully or partially elect out of subchapter K.

Timing of Election

An unincorporated organization wishing to make a **full** §761(a) election must do so not later than the due date **(including extensions)** for filing the partnership return for the first tax year for which exclusion from subchapter K is desired. The due date is generally the 15th day of the third month following the close of the tax year (i.e., **March 15** of the following year for calendar year filers).[75]

Deemed Election. An unincorporated organization that does not make the election may, nevertheless, be deemed to have done so if facts and circumstances show that at the time of its formation, it was the intention of the co-owners to opt out of subchapter K beginning with the first tax year of the organization. Facts that may indicate the requisite intent include the following.

- When formed, the co-owners agreed that the organization be excluded from subchapter K beginning with the first tax year of the organization.
- Co-owners of substantially all the organization's capital interests report their respective shares of income, deductions, and credits on their respective returns (making any appropriate elections relating to individual items) consistent with the exclusion of the organization from subchapter K beginning with the first tax year of the organization.

Revocation

Once made, a §761(a) election is effective unless a member revokes it.

A §761(a) election can be revoked within 90 days from the formation of the organization if any co-owner notifies the IRS that they wish subchapter K to apply to the organization, and that the other co-owners have been so notified by registered or certified mail. Once made, this decision is generally irrevocable absent IRS approval to the contrary.

Application for permission to revoke the decision to apply subchapter K must be submitted to the Commissioner of Internal Revenue, Attention: T:I, Washington, DC 20224, no later than 30 days after the beginning of the first tax year to which the revocation is to apply.

Method for Making the §761(a) Election

A §761(a) election for complete exclusion from subchapter K is made in a statement attached to, or incorporated in, Form 1065 which, besides the statement, need only show the name and address of the organization.

The §761(a) election statement attached to Form 1065 should include the following information.

1. Names, addresses, and identification numbers of all the members of the organization
2. A statement that the organization is an **eligible** unincorporated organization[76]
3. A statement that the co-owners of the organization elect full exclusion from subchapter K
4. A statement indicating where the organization's written operating agreement can be obtained (or if oral, who should be contacted for information)

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74. Treas. Reg. §1.761-2.

75. IRC §6072(b).

76. Under subparagraphs (1) and either (2) or (3) of paragraph (a) of Treas. Reg. §1.761-2(a).

This return must then be sent to the IRS address that would apply if it was a partnership return. For this purpose, the principal office or place of business of the person filing the return is considered the principal office or place of business of the organization.

Note. The IRS centers accepting partnership returns are Kansas City, MO and Ogden, UT. The applicable mailing address depends upon the location of the principal office or place of business of the organization and whether the organization's assets are less than $10 million.[77]

Example 7. Childhood friends, Emily, Mary, Matt, and Moe have equal shares of a $1 million rental property that they purchased together on January 1, 2021. Each of the four co-owners reserves the right to take or dispose separately of their share of the property.

After consulting with their tax advisor, Pied Piper, CPA, the four calendar year co-owners decide to completely elect out of subchapter K. They have no written operating agreement. Instead, the co-owners nominate Emily to handle any inquiries regarding the nature of their oral agreement and instruct Pied Piper to prepare and file the required §761(a) election.

Pied Piper prepares the following election attachment with its Form 1065.

EMMM Property Venture — IRC §761(a) Election Statement

Co-owner Name	Address	Identification Number
Emily Adams	100 First Street, Chitown, IL 66000	111-22-3333
Mary Brown	200 Second Street, Browntown, AK 99000	222-33-4444
Matt Charles	300 Third Street, Charleston, SC 29000	333-44-5555
Moe Dobbs	400 Fourth Street, Dobbstown, DE 19000	444-55-6666

EMMM Property Venture is an eligible unincorporated organization under subparagraphs (1) and (2) of paragraph (a) of Treas. Reg. §1.761-2(a).

The four co-owners of EMMM Property Venture hereby elect full exclusion of EMMM Property Venture from subchapter K of the Internal Revenue Code.

Details of EMMM Property Venture's oral operating agreement are available from Emily Adams at the address shown above.

INVALID §761(A) ELECTION

As previously mentioned, an election out of subchapter K may be invalid. An IRS 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."[78] Obviously, this could entail penalties for failure to file partnership returns, unless the IRS can be convinced there is reasonable cause for abatement.[79] Currently, this penalty amounts to $220 per partner per month the return is late.[80]

77. See "*Where to File Your Taxes" (for Form 1065)*. Sep. 2, 2021. IRS. [www.irs.gov/filing/where-to-file-your-taxes-for-form-1065] Accessed on Jul. 6, 2022.

78. FSA 001917 (Oct. 8, 1996).

79. IRC §6698.

80. Rev. Proc. 2021-45, 2021-48 IRB 764.

CAPITAL ACCOUNTS

To establish their investment in a partnership, each partner has a capital account. A partner's capital account tracks additions to and deductions from the partner's initial capital investment. Starting with their initial investment, the account is increased by cash and property contributions and profit allocations. Cash and property distributions and loss allocations reduce a partner's capital account.

Prior to 2020, a partnership could report its partners' capital accounts using one of the following methods.[81]

1. Tax basis
2. Generally accepted accounting principles (GAAP)
3. IRC §704(b) book amounts based on the **FMV** of contributed assets[82]
4. Other[83]

> **Note.** See the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues, for more information on pre-2020 partner capital account reporting options. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Starting with tax years ending on or after December 31, 2020, the IRS replaced these options with the requirement that partnerships report each partner's capital account using the **transactional approach** for the **tax basis** method.[84] The switch to tax basis reporting of partners' capital accounts helps partners determine their tax basis in their partnership interest to determine the following.

1. The amount of their pass-through losses they can deduct[85]
2. Income tax consequences of partnership distributions of money and property[86]
3. Gain or loss on a sale or other disposition of their partnership interest[87]

> **Note.** Besides the §704(d) basis limitation, investors in partnerships should also be aware of the at-risk rules and passive activity loss rules. Detailed information regarding the application of these rules is available in the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Individual Taxpayer Issues and the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Partner Issues. The latter can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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81. See the 2019 instructions for Form 1065.
82. The capital accounting rules under Treas. Reg. §1.704-1(b)(2)(iv).
83. A statement attached to Form 1065 is required describing the method for calculating the partner's capital account.
84. See the 2020 instructions for Form 1065.
85. IRC §704(d).
86. IRC §§731 and 732.
87. IRC §§736 and 741.

CONTRIBUTION OF PROPERTY

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

IRC §721 controls the formation of a partnership. Generally, **neither gain nor loss is recognized** by a partnership or its partners on the contribution of property to the partnership in exchange for a partnership interest.[88]

CAPITAL INTEREST FOR SERVICES

A capital interest entitles a partner to a share of the assets of the partnership upon liquidation, net of any partnership liabilities.[89] Rules for the treatment of the receipt of capital interests for services have been fairly well settled for both the service provider and the partnership.

Capital Interest for Past Services

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

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

Note. Proposed regulations issued in 2005, if finalized, will treat the compensation differently on the books of the partnership.[90]

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

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

1. A compensation payment/receipt transaction and a property disposition/acquisition transaction, followed by
2. A recontribution of the acquired property to the partnership in exchange for the partnership interest.[91]

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88. IRC §721(a).

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

90. REG-105346-03, 2005-24 IRB 1244.

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

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

Capital Interest for Future Services

If a partner receives a capital interest conditioned on the promise of future services, the rules applicable under IRC §83 for transfers of restricted interests in property are generally considered applicable to the transfer, even without the explicit provision in the proposed regulations. The service provider may wait until completion of the services to include the value in income (at ordinary rates). The service provider is not treated as a partner for tax purposes until the interest vests.[92] Consequently, the service provider is treated as an employee or independent contractor, so that any distributions from the partnership are treated as additional compensation income, the payments are deductible (or capitalizable) to the partnership under general tax principles, and the special rules applying to payments to partners under IRC §707 should not apply.

Alternatively, the service provider may make an election under §83 (within 30 days)[93] to recognize the interest as compensation in the year the partnership interest is initially transferred.[94] The partnership interest is valued at the time of the election as though there were no restrictions, and the service provider is treated as a partner at that time. Any additional distributions are treated as distributions to a partner rather than additional compensation to the service provider. Because the value upon the initial transfer may be considerably less than in the future after the services are completed, this election may effectively convert what would otherwise be ordinary compensation income into capital gain. However, if the conditions are not satisfied and the service partner forfeits the interest, they are not allowed a related deduction for the basis in the forfeited interest.[95]

Profits Interest for Services

A profits interest generally refers to the right to share in the future income of the partnership. Rules for the treatment of the receipt of profits interests have faced considerable uncertainty and controversy. Private equity funds and hedge funds effectively established a rule that the receipt of an interest in future profits is usually taxable only as those profits are actually realized, and then taxed not as compensation income but rather as characterized by the partnership's assets to which the profits are related. Court cases and interpretative regulations have generally followed that interpretation, finding profits interests taxable upon receipt only if the value is relatively fixed and determinable.[96]

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92. Treas. Reg. §1.83-1(a)(1).
93. Rev. Proc. 2012-29, 2012-28 IRB 49.
94. IRC §83(b).
95. IRC §83(b)(1).
96. Rev. Proc. 93-27, 1993-24 IRB 6; IRS Notice 2005-43, 2005-24 IRB 1221; *Hale, et. al. v. Comm'r,* 24 TCM 1497 (1965); but see *Diamond v. Comm'r,* 492 F.2d 286 (1974); GCM 36346 (Jul. 25, 1977); *Kenroy v. Comm'r,* 47 TCM 1749 (1984); and *Campbell v. Comm'r,* 943 F.2d 815 (8th Cir. 1991).

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

- The partnership does not have a substantially certain income stream,
- The interest is not disposed of within two years of its receipt, and
- The partnership interest is not publicly traded.[97]

The event that causes vesting will also not be a taxable event if the following additional requirements set forth in Rev. Proc. 2001-43 are satisfied.[98]

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

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

TAX BASIS METHOD REPORTING[99]

In August 2020, the IRS issued Notice 2020-43, describing two proposed methods for complying with the tax basis capital reporting requirement and requesting public comments. Subsequently, the IRS issued instructions for preparation of Forms 1065 which, after considering the public comments received to Notice 2020-43, limits compliance to a single methodology as discussed next.

Transactional Approach Defined[100]

Generally, when using the transactional approach of **tax basis** methodology, partners' tax capital accounts are **increased** by:

- The amount of money contributed by the partner to the partnership;
- The **tax basis** of property contributed by the partner to the partnership (less any liabilities assumed by the partnership under IRC §752);
- Allocations of partnership income or gain to the partner (including tax-exempt income and other required special allocations but **not** guaranteed payments); and
- Excess depletion.

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

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

99. 2021 instructions for Form 1065; *Partnership tax basis capital reporting requirement for tax year 2020*. Hewines, Ivan, Eckert, Stephen; and Monaghan, Michael. Jan. 13, 2021. Plante Moran. [www.plantemoran.com/explore-our-thinking/insight/2021/01/partnership-tax-basis-capital-reporting-requirement-for-tax-year-2020] Accessed Apr. 29, 2022; *Insight into Schedule K-1 Reporting, Tax Basis Capital Account Reporting*. 2021. KPMG. [assets.kpmg/content/dam/kpmg/us/pdf/2021/03/ai-tax-matters-tax-basis-capital-account-reporting.pdf] Accessed on Apr. 29, 2022.

100. See also IRC §705.

Partners' tax capital accounts are then **decreased** by the following.

- The amount of money distributed by the partnership to the partner
- The **tax basis** of property distributed to the partner (less any liabilities secured by the distributed property assumed by the partner under §752)
- Allocations to the partner of the partnership's nondeductible or noncapital expenditures
- Allocations of partnership loss and deductions
- The allocable amount of the partnership's deduction for depletion of oil and gas property

Note. Partnerships that have historically used **tax basis** reporting of capital accounts will obviously have an easier transition to the new reporting requirements. Nevertheless, certain adjustments may still be required to meet compliance, for example, exclusion of any IRC §743(b) adjustments (for transfers of partnership interests) that were included in a partner's capital account (discussed later).

AFFECTED PARTNERSHIPS

Partners' capital accounts reporting requirements are **voluntary** for partnerships that meet **all four** of the following conditions (Form 1065, Schedule B, *Other Information,* Question 4).

1. The partnership's total receipts for the tax year were **less than** $250,000.
2. The partnership's total assets at the end of the tax year were **less than** $1 million.
3. Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return.
4. The partnership is not filing and is not required to file Schedule M-3, *Net Income (Loss) Reconciliation for Certain Partnerships.*

CAPITAL ACCOUNT PARTNERSHIP REPORTING REQUIREMENTS

When applicable, a partnership's capital account reporting requirements relating to its partners includes the following additional schedules to the Form 1065.

- Schedule L, *Balance Sheets per Books*
- Schedule M-1, *Reconciliation of Income (Loss) per Books With Income (Loss) per Return*
- Schedule M-2, *Analysis of Partners' Capital Accounts*
- Item F (page 1 of Form 1065), *Total Assets*
- Schedule K-1, part II, item L, *Partner's Capital Account Analysis*

Additionally, a Form 1065, Schedule M-3 **must** be filed by a domestic partnership, common trust fund, or foreign partnership that meets **any** of the following conditions.

- The amount of total assets at the end of the tax year reported by the partnership (Form 1065, part II, Schedule L, line 14, column (d)) equals $10 million or more.
- The amount of the partnership's adjusted total assets for the tax year equals $10 million or more.
- The partnership's total receipts for the tax year equals $35 million or more.
- An entity that is a reportable entity partner with respect to the partnership (as defined in the Form 1065 instructions) owns or is deemed to own, directly or indirectly, an interest of 50% or more in the partnership's capital, profit, or loss on any day during the partnership's tax year.

Practitioner Planning Tip

In order to properly compute basis, the balance sheet information is critical. Even though it is voluntary, practitioners are encouraged to include a balance sheet.

The following example illustrates how a partnership calculates and reports the tax basis capital accounts for the partners.

Example 8. In January 2021, STR LP, a calendar year partnership, was formed to purchase and operate short-term residential units. Tenants of STR's rental units receive repairs, maintenance, gardening, and laundry services from the partnership. Each of the 10 partners contributed $100,000 cash to the partnership in exchange for a 10% interest. The partnership used the $1,000,000 (10 partners × $100,000 each) to acquire property at a cost basis of $900,000, which was allocated as $800,000 to depreciable assets and $100,000 to land. The 2021 operations of the partnership resulted in net income of $60,000 (which included depreciation deductions of $100,000) and the partnership distributed cash of $40,000.

The STR LP Schedules L, M-1, and M-2 from the 2021 Form 1065 follow.

For Example 8

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Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 21	1	60,000

2 Analysis by partner type:	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt Organization	(vi) Nominee/Other
a General partners						
b Limited partners			60,000			

Schedule L — Balance Sheets per Books

Assets	Beginning of tax year (a)	(b)	End of tax year (c)	(d)
1 Cash				220,000
2a Trade notes and accounts receivable				
b Less allowance for bad debts				
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities				
6 Other current assets (attach statement)				
7a Loans to partners (or persons related to partners)				
b Mortgage and real estate loans				
8 Other investments (attach statement)				
9a Buildings and other depreciable assets			800,000	
b Less accumulated depreciation			100,000	700,000
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				100,000
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets (attach statement)				
14 Total assets				1,020,000
Liabilities and Capital				
15 Accounts payable				
16 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities (attach statement)				
18 All nonrecourse loans				
19a Loans from partners (or persons related to partners)				
b Mortgages, notes, bonds payable in 1 year or more				
20 Other liabilities (attach statement)				
21 Partners' capital accounts				1,020,000
22 Total liabilities and capital				1,020,000

Schedule M-1 — Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: The partnership may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books	60,000	6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize): a Tax-exempt interest $	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):				
3	Guaranteed payments (other than health insurance)		7	Deductions included on Schedule K, lines 1 through 13d, and 21, not charged against book income this year (itemize): a Depreciation $	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 21 (itemize): a Depreciation $ b Travel and entertainment $		8	Add lines 6 and 7	
5	Add lines 1 through 4	60,000	9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	60,000

Schedule M-2 — Analysis of Partners' Capital Accounts

1	Balance at beginning of year		6	Distributions: a Cash	40,000
2	Capital contributed: a Cash	1,000,000		b Property	
	b Property		7	Other decreases (itemize):	
3	Net income (loss) (see instructions)	60,000			
4	Other increases (itemize):		8	Add lines 6 and 7	40,000
5	Add lines 1 through 4	1,060,000	9	Balance at end of year. Subtract line 8 from line 5	1,020,000

Form **1065** (2021)

Below is the Item L from the Schedule K-1 of each partner.

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L	Partner's Capital Account Analysis		22	☐ More than one activity for at-risk purposes*
	Beginning capital account	$ 0	23	☐ More than one activity for passive activity purposes*
	Capital contributed during the year	$ 100,000		*See attached statement for additional information.
	Current year net income (loss)	$ 6,000		
	Other increase (decrease) (attach explanation)	$		
	Withdrawals and distributions	$ (4,000)		
	Ending capital account	$ 102,000		

Observations:

1. Because this is the first year of the partnership, there is no beginning balance sheet or capital account.
2. If the Item L lines for all of the partners were totaled, the totals should agree to the respective amounts in the Schedule M-2 of Form 1065.
3. Although STR LP, was required to complete Schedules L, M-1, and M-2 because the total assets were over $1 million, it is prudent for the preparer to complete these forms for future reference and capital account tracking over the years of the partnership.
4. Schedule M-2, beginning and ending capital should always agree to Line 21 of Schedule L.

ADJUSTMENTS FOR TRANSFERS OF PARTNERSHIP INTERESTS[101]

The two circumstances when a transfer of an interest in a partnership by sale or exchange or on the death of a partner requires an adjustment to basis are when:

1. The partnership has a §754 election in effect, or
2. The partnership has a substantial built-in loss immediately after such transfer.

In either case, the partnership is required to take the following action immediately after the transfer.

- **Increase** the adjusted basis of partnership property by the **excess** of the basis to the transferee partner of their interest in the partnership over their proportionate share of the adjusted basis of partnership property, **or**
- **Decrease** the adjusted basis of partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of their interest in the partnership.

The resulting increase or decrease constitutes an adjustment to the basis of partnership property with respect to the **transferee partner only.** Consequently, the partnership must now keep track of this property basis of the transferee partner.

> **Note.** It is the **partnership's** responsibility to make this adjustment to the basis of partnership property[102] and to file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, with the partnership return. The partnership should also provide copies of Form 8308 to the transferor and transferee of the partnership interest.

101. IRC §743(b).

102. *Reporting aspects of Sec. 743(b) adjustments*. Kim, Grace. Feb. 1, 2022. The Tax Adviser. [www.thetaxadviser.com/issues/2022/feb/reporting-aspects-sec-743b-adjustments.html] Accessed on Jun. 29, 2022.

IRC §754 Election[103]

> **Note.** The terms **inside basis** and **outside basis** are defined and explained later in this chapter.

When made by a partnership, a §754 election steps up the partnership's **inside basis** — but only for a new partner. Consequently, the **inside basis** of the new partner's share of partnership property equals the new partner's **outside basis** of their partnership interest **potentially reducing the new partner's exposure to capital gains tax upon sale of partnership property.** In addition, with a IRC §754 election, the partner with basis step-up will have a special allocation for depreciation.

Example 9. Use the same facts as in **Example 8,** except that in January 2021, STR LP purchases $1 million of rental properties, and on January 1, 2022, Joanna sells her 10% partnership interest to Roger for $150,000. Joanna's taxable gain is $48,000 ($150,000 – $102,000 tax basis).

Absent a §754 election, Roger's **outside basis** is $150,000, but the partnership property's **inside basis** of $102,000 carries over to Roger. Consequently, Roger would have a $48,000 taxable gain if the partnership was to immediately sell its property for $1,500,000, which is the value implied by Roger's purchase of Joanna's partnership interest ($150,000 per partner × 10 partners). However, Roger would have a $48,000 loss if he were to immediately dispose of his partnership interest for the amount of his inside basis ($150,000 outside basis – $102,000 inside basis).

By making a §754 election at the time of Joanna's ownership transfer, Roger's **inside basis** of the partnership's property would be increased from $102,000 to $150,000 thus equal to his **outside basis**. Consequently, Roger would have no gain or loss if the partnership was to immediately sell its property. Specially allocated depreciation would likely be applicable, but is not addressed in this example.

> **Note.** When a transferee partner's **inside basis** of partnership property is increased as a result of a §754 election, this will results in that partner receiving a special depreciation allocation equal to the depreciation allowable that exceeds the depreciation that would have been allowable absent the §754 election.

Substantial Built-In Loss[104]

A partnership has a substantial built-in loss with respect to a transfer of an interest in the partnership if:

1. The partnership's adjusted basis in the partnership property exceeds by more than $250,000 the FMV of that property, **or**
2. The acquiring partner would be allocated a loss of more than $250,000 if the partnership's property was sold for its FMV immediately after such transfer.[105]

Therefore, there are two tests for a substantial built-in loss. The first applies to the partnership and the second to the acquiring partner.

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103. *What is a 754 Election?* 2021. Wolters Kluwer. [www.cchcpelink.com/w/what-is-a-754-election] Accessed on May 6, 2022.

104. IRC §743(d); *Questions and Answers about the Substantial Built-in Loss Changes under Internal Revenue Code (IRC) Section 743*. Jul. 21, 2021. IRS. [www.irs.gov/newsroom/questions-and-answers-about-the-substantial-built-in-loss-changes-under-internal-revenue-code-irc-section-743] Accessed on May 6, 2022.

105. Added by the *Tax Cuts and Jobs Act,* PL 115-97, §13502.

In applying these tests, the partnership's assets are treated as sold for cash at their FMV immediately after the transfer of a partnership interest. Even if there is no substantial built-in loss at the partnership level, there may nevertheless be a substantial built-in loss for the acquiring partner if the hypothetical sale of one or more partnership assets would result in a substantial built-in loss.

When a substantial built-in loss occurs, the partnership must adjust the basis of its assets to the acquiring partner.

This substantial built-in loss definition applies to sales or exchanges of partnership interests occurring after December 31, 2017.

Example 10. Partnership VWXY has **four** partners (Victor, Will, Xavi, and Yair) and assets consisting of two mortgage-free properties which cost $3 million each.[106] Property Alpha has a current built-in gain of $1.6 million. Beta property has a built-in loss of $1.2 million. Thus, the partnership nets a $400,000 built-in gain. Under the terms of the partnership agreement, any gain on sale or exchange of Alpha is specially allocated to Yair. Otherwise, all partners share equally in other partnership items.

Victor sells his 25% share in the partnership to acquiring partner Zane for $1.2 million (25% of the net FMV of the partnership i.e., $6 million – $1.2 million built-in loss). Although the partnership has a net built-in gain, Zane's 25% share in Beta property's $1.2 million built-in loss is $300,000, making this a **substantial built-in loss** for Zane.

Victor's **inside** basis in the partnership's property is $1.5 million ($6 million x 25%) but Zane's **outside** basis is $1.2 million. Therefore, because there is a substantial built-in loss for Zane, the acquiring partner, Partnership VWXY must make a $300,000 §743(b) **reduction** of the **inside** basis of Beta property for Zane (i.e., by the excess of Zane's **inside** basis over Zane's **outside** basis), thus, **balancing** Zane's inside and outside bases.

Absent this §743(b) adjustment, Zane would get a $300,000 loss if the partnership was to immediately sell property Beta even though Zane had not economically sustained this loss.

Assuming the partnership's property is depreciable, Zane would get reduced depreciation deductions.

Note. The §754 and §743 adjustments require special bookkeeping for special allocations. In addition, each asset on the depreciation schedule must be split pro rata.

106. Example is based on Q5 of *Questions and Answers about the Substantial Built-in Loss Changes under Internal Revenue Code (IRC) Section 743*. Jul. 21, 2021. IRS. [www.irs.gov/newsroom/questions-and-answers-about-the-substantial-built-in-loss-changes-under-internal-revenue-code-irc-section-743] Accessed on May 6, 2022.

PROPERTY CONTRIBUTIONS TO A PARTNERSHIP[107]

TAX CONSEQUENCES[108]

Generally, **no** gain (loss) is recognized either by the partnership or by any partners when property is contributed to the partnership in exchange for an interest in the partnership.

Non-Member Transactions[109]

A partner who engages in a transaction with a partnership, not in their capacity as a partner, is treated as **not** being a **member** of the partnership for that transaction. Because of this rule, a partner engaging in a transfer of property to a partnership in exchange for a direct or indirect transfer of money or other property from the partnership, may have to individually recognize gain on the exchange if the transaction is considered a **disguised sale.**

A disguised sale is considered to occur if the following conditions are met.[110]

1. The transfer of money or other consideration would not have been made but for the transfer of the property; and
2. If the transfers are not simultaneous, the subsequent transfer (either of money or property) does not depend on the entrepreneurial risks of partnership operations.

Disguised Sales. Partnership rules do not include a provision that is comparable to IRC §351(b), which provides for gain recognition when any shareholder/transferor receives some consideration other than stock (boot) for items transferred to the corporation.

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

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

A distribution and a concurrent contribution are likely to be recast in whole or in part as a sale under the disguised sale rules.[111] If the transfer does not result in the application of the disguised sale rules, any gain from the distribution is treated as recognized on the sale of the partnership interest rather than on the contributed property.

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

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107. IRS Pub. 541, *Partnerships*; *Tax Information For Partnerships,* Dec. 7, 2021. IRS. [www.irs.gov/businesses/partnerships] Accessed on Sep. 9, 2022; Instructions for Form 1065.

108. IRC §721.

109. IRC §707.

110. Treas. Reg. §1.707-3(b)(1). For more information on disguised sales, see *Recognizing When a Disguised Sale of Property Takes Place*. Ellentuck, Albert B. Aug. 1, 2016. The Tax Adviser. [www.thetaxadviser.com/issues/2016/aug/recognizing-disguised-sale-of-property.html] Accessed on May 11, 2022.

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

This determination is based on the substance of the transaction, not its form.[112] The intent is to capture as sales a contribution and a related distribution that, when combined, effectively allow a partner to withdraw part or all of their equity in the contributed property from the partnership. Contributions that are actually exchanged for an interest in the partnership and subject to a risk of loss in the enterprise are not intended to be treated as sales. The contribution and distribution of money or other property is treated as a sale **only if,** considering all the facts and circumstances:

- The transfer from the partnership would not have been made but for the transfer of the property; and
- If not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risk of the partnership operations.[113]

Contributions and related distributions that are treated as sales are treated as occurring on the date the partnership becomes the owner of the property under general federal tax principles. If the consideration from the partnership is transferred after the transfer of the property to the partnership, it is treated as a deferred payment sale in which the partnership has an obligation to transfer consideration to the partner as of the date of the property's transfer to the partnership.[114]

The regulations provide the following list of circumstances that may tend to prove a sale.[115]

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

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

113. Treas. Reg. §1.707-3(b)(1).

114. Treas. Reg. §1.707-3(a)(2).

115. Treas. Reg. §1.707-3(b)(2).

There is a presumption that a contribution and distribution made within two years of each other (without regard to order) constitute a sale (the 2-year presumption). The 2-year presumption can be rebutted only with facts that **clearly establish** that the transfers are not a sale.[116]

> **Note.** Disclosure of a contribution and distribution made within two years of each other **must be made** by the partnership on Form 8275, *Disclosure Statement.*[117]

Exceptions. Exceptions to the disguised sales rules include distributions that are guaranteed payments for capital, preferred returns, operating cash flow distributions, or reimbursements of preformation expenditures.[118] The critical issue for both guaranteed payments on capital and preferred returns is that they provide a return **on** investment, not a return **of** the partner's investment in the partnership.

A **guaranteed payment** is "determined without regard to partnership income and is for the use of that partner's capital."[119] As long as a payment that is characterized by the partners as a guaranteed payment is determined without regard to the income of the partnership and is "reasonable," it will be presumed to be a guaranteed payment. Accordingly, the 2-year presumption does not apply, unless the facts clearly establish that it is in fact a partial sale.[120]

A **preferred return** is "a preferred distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain."[121] As long as a payment that is characterized as a preferred return is reasonable, it is presumed to be a preferred return and not a sale. Accordingly, the 2-year presumption does not apply, unless the facts (including the likelihood and expected timing of later distributive shares of partnership income to support the preferred return) clearly establish otherwise.

A guaranteed payment or preferred return is considered reasonable if the transfers are made pursuant to a written agreement, provide for a reasonable amount in return for the use of capital, and the payment is made after the provision is added to the agreement.[122] The amount is reasonable if the sum of the guaranteed payments and preferred returns from the time the right is established through the end of the year is not more than the partner's unreturned capital multiplied by the safe harbor interest rate (150% of the highest applicable federal rate).[123] The partners have an option to use a weighted average capital balance for the year rather than the unreturned capital.

Example 11. Catherine transfers a lot with an FMV of $4,000 and an adjusted tax basis of $1,200 to a partnership, and the partnership immediately transfers $3,000 cash to Catherine.[124] The distribution is not characterized as a guaranteed payment or a preferred return to Catherine. Her share of the partnership's net cash flow for the year is $0.

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

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

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116. Treas. Reg. §1.707-3(c). Transfers made more than two years apart are presumed not to be a sale under Treas. Reg. §1.707-3(d).
117. Treas. Reg. §§1.707-3(c)(2) and 1.707-8.
118. Treas. Reg. §1.707-4.
119. Treas. Reg. §1.707-4(a)(1)(i).
120. Treas. Reg. §1.707-4(a)(1)(ii).
121. Treas. Reg. §1.707-4(a)(2).
122. Treas. Reg. §1.707-4(a)(3)(i).
123. Treas. Reg. §1.707-4(a)(3)(ii).
124. This example is based on Treas. Reg. §1.707-3(f), Example 1.

Example 12. Use the same facts as **Example 11,** except that the transfer from the partnership is only $1,000. Catherine's share of the partnership's net cash flow for the year is $1,000, and a proportional distribution is made to each of the other partners at the same time.

Question. Is this a disguised sale?

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

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

> **Note.** For more information on disguised sales, see IRS Pub. 541, *Partnerships.*

DISPOSITIONS OF CONTRIBUTED PROPERTY[125]

Generally, if a partnership disposes of property contributed to the partnership by a partner, income, gain, loss, and deductions from that property must be **allocated** among the partners to account for the difference between the property's tax basis and its FMV at the time of the contribution.

Under the traditional method for making these **§704(c) allocations,** if the partnership sells §704(c) property and recognizes gain or loss, the built-in gain or loss on the property is allocated to the contributing partner.[126] Other methods for doing these allocations are described in the Treasury Regulations.[127]

> **Note.** See the instructions for Form 1065 regarding the reporting of §704(c) partner allocations, specifically Schedule K-1 (Form 1065) Item N, line 19b, box 20 code W, and qualified business income (QBI) information code AA. See also IRS Notice 2019-66.[128]

However, where the adjusted basis of the contributed property exceeds its FMV at the time of the contribution, the built-in loss **must** be taken into account by the contributing partner. For all other partners, the basis of the property in the hands of the partnership is treated as equal to its FMV at the time of the contribution (see §704(c)(1)(C)).

These provisions were particularly important when partnerships could adopt the §704(b) book accounting method for partner capital accounts based on the FMV rather than the tax basis of contributed property.

> **Note.** See the 2017 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Partnership Issues for more information on §704(c) allocations including examples. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

125. IRC §704(c).
126. Treas. Reg. §1.704-3(b).
127. Treas. Reg. §1.704-3.
128. IRS Notice 2019-66, 2019-52 IRB 1509.

Distributions of Property to Another Partner[129]

The **contributing** partner must recognize a gain or loss if:

- The partnership distributes property with pre-contribution gain or loss to **another** partner, and
- The date of the distribution is within **seven years** of the date the property was contributed to the partnership.

The gain or loss is equal to the amount that the contributing partner should have recognized if the property had been sold for its FMV when distributed (i.e., the difference between the property's basis and its FMV at the time of contribution).

Tax Reporting.[130] A partnership making such a distribution must:

1. Report the distribution in box 20, code W of the contributing partner's Schedule K-1, and
2. Attach a statement thereto providing the amount of the contributing partner's pre-contribution gain or loss and identifying the character of the gain or loss (e.g., capital gain or loss or §1231 gain or loss).

The contributing partner reports the pre-contribution gain or loss on Form 8949, *Sales and other Dispositions of Capital Assets,* Schedule D, *Capital Gains and Losses,* or Form 4797, *Sales of Business Property,* based on the characterization of the gain or loss by the partnership.

Example 13. Andy contributes land with a built-in gain of $10,000 (FMV $100,000 less $90,000 adjusted basis) to the ABC Partnership. Two years later, ABC Partnership distributes the land to another partner when the land's FMV is $125,000 resulting in a total gain of $35,000 ($125,000 – $90,000 adjusted basis).

Andy must be allocated the $10,000 initial built-in gain. The remaining $25,000 gain is a deferred gain that is allocated among **all** the partners in the partnership (including Andy) in proportion to their interests and is not currently recognizable. Each partner's capital account is reduced accordingly.

ABC provides Andy with the following Schedules K-1, L, M, and associated statement.

111111 ABC PARTNERSHIP
11-1223333
FYE: 12/31/2021

Federal Statements
ANDY SMITH
555-55-5555

Schedule K-1, Item M - Property Contributed with a Built-In Gain or Loss

Property Contributed	Date Contributed	Built-In Gain (Loss)
LAND	1/01/20	$ 10,000

Schedule K-1, Line 20W - Precontribution Gain (Loss)

Description	Character of Gain (Loss)	Precontribution Gain (Loss)
Built in Gain on Land	Capital	$ 10,000
Total		$ 10,000

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129. IRC §704(c)(1)(B).

130. See the 2021 Partner's Instructions for Schedule K-1 (Form 1065).

For Example 13

3

Partner# 1

651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

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

Part I Information About the Partnership

A Partnership's employer identification number
11-1223333

B Partnership's name, address, city, state, and ZIP code
ABC Partnership

C IRS center where partnership filed return ▶

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

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
555-55-5555

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Andy Smith

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

H1 ☒ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner? **Individual**

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

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

	Beginning	Ending
Profit	50.000000 %	50.000000 %
Loss	50.000000 %	50.000000 %
Capital	50.000000 %	50.000000 %

Check if decrease is due to sale or exchange of partnership interest . ▶ ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 90,000
Capital contributed during the year . .	$
Current year net income (loss)	$
Other increase (decrease) (attach explanation)	$
Withdrawals and distributions	$ ( )
Ending capital account	$ 90,000

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

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $ 10,000
Ending . . . . $

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

1	Ordinary business income (loss)	14	Self-employment earnings (loss)
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . ▶ ☐
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses
6c	Dividend equivalents		
7	Royalties		
8	Net short-term capital gain (loss)	19	Distributions
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)	20	Other information
9c	Unrecaptured section 1250 gain	W*	10,000
10	Net section 1231 gain (loss)		
11	Other income (loss)		
12	Section 179 deduction	21	Foreign taxes paid or accrued
13	Other deductions		

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2021

For Example 13

Form 1065 (2021) **ABC Partnership** **11-12223333** Page **5**

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 21					1	
2	Analysis by partner type:	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt Organization	(vi) Nominee/Other
a	General partners						
b	Limited partners						

Schedule L Balance Sheets per Books

		Beginning of tax year		End of tax year	
	Assets	(a)	(b)	(c)	(d)
1	Cash		100,000		100,000
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts				
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities				
6	Other current assets (attach statement)				
7a	Loans to partners (or persons related to partners)				
b	Mortgage and real estate loans				
8	Other investments (attach statement)				
9a	Buildings and other depreciable assets	90,000		0	
b	Less accumulated depreciation		90,000		0
10a	Depletable assets				
b	Less accumulated depletion				
11	Land (net of any amortization)				
12a	Intangible assets (amortizable only)				
b	Less accumulated amortization				
13	Other assets (attach statement)				
14	Total assets		190,000		100,000
	Liabilities and Capital				
15	Accounts payable				
16	Mortgages, notes, bonds payable in less than 1 year				
17	Other current liabilities (attach statement)				
18	All nonrecourse loans				
19a	Loans from partners (or persons related to partners)				
b	Mortgages, notes, bonds payable in 1 year or more				
20	Other liabilities (attach statement)				
21	Partners' capital accounts		190,000		100,000
22	Total liabilities and capital		190,000		100,000

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: The partnership may be required to file Schedule M-3. See instructions.

1	Net income (loss) per books		6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):		a	Tax-exempt interest $	
3	Guaranteed payments (other than health insurance)		7	Deductions included on Schedule K, lines 1 through 13d, and 21, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 21 (itemize):		a	Depreciation $	
a	Depreciation $		8	Add lines 6 and 7	
b	Travel and entertainment $		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	0
5	Add lines 1 through 4				

Schedule M-2 Analysis of Partners' Capital Accounts

1	Balance at beginning of year	190,000	6	Distributions: a Cash	
2	Capital contributed: a Cash			b Property	90,000
	b Property		7	Other decreases (itemize):	
3	Net income (loss) (see instructions)				
4	Other increases (itemize):		8	Add lines 6 and 7	90,000
5	Add lines 1 through 4	190,000	9	Balance at end of year. Subtract line 8 from line 5	100,000

Form **1065** (2021)

DETERMINING A PARTNER'S TAX BASIS[131]

The focus of this next section changes from the partner capital account reporting requirements on the partnership return to determining a partner's tax basis in their partnership investment from the perspective of the partner's personal tax return.

The instructions for Form 1065 state that "Each partner is responsible for maintaining a record of the adjusted tax basis in its partnership interest." The 2021 instructions for Schedule K-1 (Form 1065) and the following IRS worksheet from the instructions assist partners to determine the tax basis of their partnership interests.

Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership *Keep for Your Records*

1. Your adjusted basis at the end of the prior year. Do not enter less than zero. Enter -0- if this is your first tax year . . . . . **1.** ______

Increases:

2. Money and your adjusted basis in property contributed to the partnership less the associated liabilities (but not less than zero) . . . . . **2.** ______

3. Your increased share of or assumption of partnership liabilities. (Subtract your share of liabilities shown in item K of your 2020 Schedule K-1 from your share of liabilities shown in item K of your 2021 Schedule K-1 and add the amount of any partnership liabilities you assumed during the tax year (but not less than zero).) . . . . . **3.** ______

4a. Your share of the partnership's income or gain (including tax-exempt income) reduced by any amount included in interest income with respect to the credit to holders of clean renewable energy bonds . . . . . **4a.** ______

4b. Enter the amount of business interest expense included on 4a . . . . . **4b.** ______

4c. Add lines 4a and 4b. If the result is less than zero, include this amount on line 10 . . . . . **4c.** ______

5. Any gain recognized this year on contributions of property. Do not include gain from transfer of liabilities . . . . . **5.** ______

6. Your share of the excess of the deductions for depletion (other than oil and gas depletion) over the basis of the property subject to depletion . . . . . **6.** ______

Decreases:

7. Withdrawals and distributions of money and the adjusted basis of property distributed to you from the partnership. Do not include the amount of property distributions included in the partner's income (taxable income) . . . . . **7.** ______

Caution: A distribution may be taxable if the amount exceeds your adjusted basis of your partnership interest immediately before the distribution.

8. Your decreased share of partnership liabilities and any decrease in your individual liabilities because they were assumed by the partnership. (Subtract your share of liabilities shown in item K of your 2021 Schedule K-1 from your share of liabilities shown in item K of your 2020 Schedule K-1 and add the amount of your individual liabilities that the partnership assumed during the tax year (but not less than zero).) . . . . . **8.** ______

9. Your share of the partnership's nondeductible expenses that are not capital expenditures (excluding business interest expense) . . . . . **9.** ______

10. Your share of the partnership's losses and deductions (including capital losses). However, include your share of the partnership's section 179 expense deduction for this year even if you cannot deduct all of it because of limitations. Include business interest expense as a separate loss class. See *Note* below. . . . . . **10.** ______

11. The amount of your deduction for depletion of any partnership oil and gas property, not to exceed your allocable share of the adjusted basis of that property . . . . . **11.** ______

12. Your adjusted basis in the partnership at the end of this tax year. (Add lines 1 through 6 and subtract lines 7 through 11 from the total. If zero or less, enter -0-.) . . . . . **12.** ______

Caution: The deduction for your share of the partnership's losses and deductions is limited to your adjusted basis in your partnership interest. If you entered zero on line 12 and the amount figured for line 12 was less than zero, a portion of your share of the partnership losses and deductions may not be deductible. (See Basis Limitations, earlier, for more information.) Also see *Part III. Partner's Share of Current Year Income, Deductions, Credits, and Other Items*, later.
Note: Include on line 10 business interest expense that was removed from the amount on line 4a. Business interest expense is considered a separate loss class under Regulations section 1.163(j)-6(h)(1). However, to the extent basis is proportionately allocated to this loss class, interest expense is absorbed by applying currently deductible business interest expense to basis first. Excess business interest expense is applied to basis second. Excess business interest expense is only applicable to partnerships subject to section 163(j). In addition, if a partnership has negative section 704(d) expense (interest expense that is limited by basis), negative section 704(d) expense becomes excess business interest expense in the year that the basis limitation no longer applies. This is effective for tax years beginning after November 12, 2020.

131. 2021 Instructions for Form 1065; 2021 Partner's Instructions for Schedule K-1 (Form 1065); *Partner's Outside Basis*. May 19, 2021. IRS LB&I Process Unit. [www.irs.gov/pub/irs-utl/partners-outside-basis.pdf] Accessed on May 4, 2022; *Insight into Schedule K-1 Reporting, Tax Basis Capital Account Reporting*. 2021. KPMG. [assets.kpmg/content/dam/kpmg/us/pdf/2021/03/ai-tax-matters-tax-basis-capital-account-reporting.pdf] Accessed on May 3, 2022.

Currently, there is no requirement for partnerships to provide complete tax basis information to their partners, although some partnerships voluntarily provide a tax basis statement as part of the partner's Schedule K-1 package. Information sources and technical rules that partners should be aware of when determining the tax basis of their partnership interests are explored next.

Usually, the **initial** basis of a partner's interest is the cash they contributed plus their adjusted basis in any property transferred to the entity in exchange for the ownership interest. The adjusted basis of contributed property must be increased by any gain recognized by the partner under §721(b).[132]

Note. For partnership investment interests that were inherited, received as a gift, or acquired via other nontraditional means, the basis is determined in accordance with the general rules for those types of acquisitions.

The resulting tax basis is also known as the **outside basis.** If the partner's interest was acquired from someone other than the partnership, the acquiring partner's **outside basis** may differ from the **inside basis,** which is the partnership's basis in its assets. In this situation, the onus is on the acquiring partner to correctly determine their **outside basis** (see the section on the §754 election for more information).

The following example illustrates how a partner can keep track of their tax basis in a partnership investment by relying solely on the information provided in Schedule K-1, part II, item L.

Example 14. Use the same facts as **Example 8.** In January 2021, Joanna Smith, contributed $100,000 cash to the partnership for her 10% share of STR LP. During 2021, she received $6,000 of income and received a cash distribution of $4,000 from the partnership.

In February 2022, Joanna receives her Schedule K-1 from the partnership for calendar year 2021. Item L of Schedule K-1 follows.

L	**Partner's Capital Account Analysis**		22 ☐ More than one activity for at-risk purposes*
	Beginning capital account	$ 0	23 ☐ More than one activity for passive activity purposes*
	Capital contributed during the year	$ 100,000	*See attached statement for additional information.
	Current year net income (loss)	$ 6,000	
	Other increase (decrease) (attach explanation)	$	
	Withdrawals and distributions	$ (4,000)	
	Ending capital account	$ 102,000	Use Only

When discussing preparation of her 2021 individual tax returns with her preparer Cathy Carson EA, Joanna refers to the IRS requirement to maintain a record of the adjusted tax basis of her partnership interest.

Cathy explains that partnerships are now required to report their partners' capital accounts using the tax basis and because Joanna's situation is straightforward, her December 31, 2021, tax basis is $102,000 (i.e., the ending capital account shown in item L of her K-1).

132. IRC §723; IRC §721(b) gains relate to transfers of property to investment companies.

The current year net income (loss) line on item L of Schedule K-1 should **include** a partner's share of tax-exempt income and nondeductible expenses as reported on the Schedule K-1 (see the following table).

Items Affecting Basis	Schedule K-1 Box 18 Code	Schedule K-1 Box 19 Code
Tax-exempt interest	A	
Other tax-exempt income	B	
Nondeductible expenses paid or incurred by the partnership	C	
Distributions of cash and marketable securities (at FMV)		A
Distributions subject to IRC §737		B
Distributions of other property		C

Note. All income received or recognized and all expenses paid or incurred affect basis.

However, item L current year net income should **exclude**:

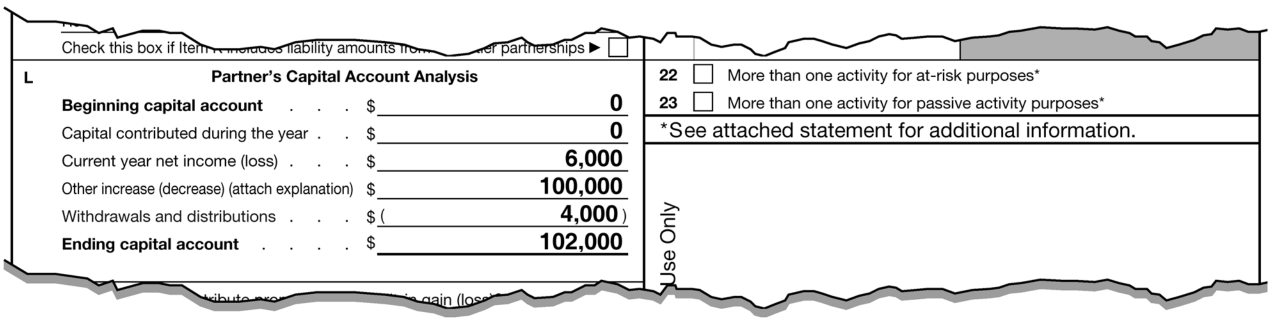
1. Guaranteed payments, or
2. Income, gain, loss, or deductions resulting from a §743(b) basis adjustment.

A statement must be attached to affected Schedules K-1 explaining each adjustment shown in Item L as an **other increase (decrease).** The following table shows examples of increases and decreases that could appear there.

Increase	Decrease
When a new partner **acquires** its interest in the partnership from another partner in a purchase, exchange, gift, or inheritance, the amount of the transferor partner's ending capital account figured using the tax basis method constitutes an **other increase.**	When a transferor partner **disposes** of its interest in the partnership by sale, exchange, gift, or as the result of death, the amount of the transferor partner's ending capital account figured using the tax basis method constitutes an **other decrease.**
The partner's distributive share of the excess of the tax deductions for depletion (other than oil and gas depletion) over the adjusted tax basis of the property subject to depletion.	The partner's distributive share of tax deductions for depletion of any partnership oil and gas property, up to the partner's share of the adjusted tax basis of that property.
The partner's share of any IRC §734(b)[a] **increase** to the adjusted tax basis of partnership property.	The partner's share of any §734(b)[a] **decrease** to the adjusted tax basis of partnership property.

[a] Adjustment to basis of undistributed partnership property where there is a §754 election or substantial basis reduction.

Example 15. Use the same facts as in **Example 14,** except that in March 2021, rather than being a founding member, Joanna purchased Paul Brown's entire interest in STR LP for $100,000 (Paul was one of the founding partners). At the time Joanna purchased Paul's interest, his tax basis in his partnership interest was $100,000. Joanna's acquisition from Paul is now shown as an **other increase** in item L of Schedule K-1 because she did not contribute any capital, as shown below.



Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L	Partner's Capital Account Analysis	
	Beginning capital account	$ 0
	Capital contributed during the year	$ 0
	Current year net income (loss)	$ 6,000
	Other increase (decrease) (attach explanation)	$ 100,000
	Withdrawals and distributions	$ (4,000)
	Ending capital account	$ 102,000

22 ☐ More than one activity for at-risk purposes*

23 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

Use Only

Unfortunately, not all partners can rely **solely** upon item L of Schedule K-1 to determine the tax basis of their partnership interest. This is because there are other factors to consider, for example, the partner's share of partnership liabilities[133] and any §743(b) adjustments (for transfers of partnership interests).

Therefore, the IRS advocated for the following more comprehensive method to establish a partner's **outside** tax basis before consideration of current year activity.

	Beginning tax basis capital account (Schedule K-1, item L "Beginning capital account")
+	Partner's share of liabilities, both recourse and nonrecourse (Schedule K-1, item K "Partner's share of liabilities")
+	Partner's share of **positive** §743(b) adjustments (Schedule K-1, line 11, code F)
–	Partner's share of **negative** §743(b) adjustments (Schedule K-1, line 13, code V)
	Partner's outside basis

PARTNER'S SHARE OF LIABILITIES[134]

Both partnership debt and partner loans to a partnership create basis for its partners. Each partner's share of partnership liabilities at the beginning and end of the year is reported on their Schedule K-1 in part II, item K.

For this purpose, a **partnership liability** is an obligation that:[135]

- 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.

Partnership 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.[136] However, a partnership obligation may not necessarily be a liability for basis purposes.

133. IRC §752.

134. IRC §752 and IRS Pub. 541, *Partnerships*; *Tax Information For Partnerships,* Dec. 7, 2021. IRS. [www.irs.gov/businesses/partnerships] Accessed on Sep. 9, 2022

135. Treas. Reg. §1.752-1(a)(4)(i).

136. Treas. Reg. §1.752-1(a)(4)(ii).

Practitioner Planning Tip

When reviewing partnership obligations, it is necessary for the tax preparer to determine if they constitute a liability for tax basis purposes.

Item K shows the following three categories of liabilities.

1. Nonrecourse
2. Qualified nonrecourse financing
3. Recourse

All these liability categories increase or decrease a partner's tax basis but **only** recourse and qualified nonrecourse debt affect the **at-risk** amount.

> **Note.** See the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Schedule K-1 for more information on these liability categories and the application of the at-risk rules. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

An assumption by a partner of a partnership's liabilities is considered a contribution of money to the partnership resulting in a **positive** adjustment (adding to their tax basis). Conversely, an assumption by a partnership of a partner's liabilities is considered a distribution of money to the partner resulting in a **negative** adjustment (subtracting from their tax basis).

A **positive** adjustment is entered on line 3 of the IRS Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership.[137] For 2021, this is calculated as follows.

	2021 Schedule K-1, part II, item K (sum of year-ending liabilities)
−	2020 Schedule K-1, part II, item K (sum of year-ending liabilities)
+	Partnership liabilities assumed by the partner during 2021
	Positive adjustment

A **negative** adjustment is entered on line 8 of the IRS Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership. For 2021, this is calculated as follows.

	2020 Schedule K-1, part II, item K (sum of year-ending liabilities)
−	2021 Schedule K-1, part II, item K (sum of year-ending liabilities)
+	Partnership liabilities assumed by the partner during 2021 (but not less than $0)
	Negative adjustment

137. Instructions for Schedule K-1.

Example 16. Use the same facts as in **Example 14,** except that instead of contributing $100,000 cash to the partnership, Joanna contributed property with a $100,000 adjusted basis subject to a nonrecourse liability of $20,000 which was assumed by the partnership and is the only liability assumed by the partnership in 2021.

Joanna files the following Schedule K-1, part II, items K and L entries.

Check if decrease is ... or exchange of ... interest . . ▶ ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . .	$ 0	$ 2,000
Qualified nonrecourse financing	$ 0	$ 0
Recourse	$ 0	$ 0

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 0
Capital contributed during the year . .	$ 80,000
Current year net income (loss)	$ 6,000
Other increase (decrease) (attach explanation)	$
Withdrawals and distributions	$ (4,000)
Ending capital account	$ 82,000

...tribute pro... ...ilt-in gain (loss)?

12 ... deductions

21 Foreign taxes paid ... accrued

13 Other deductions

22 ☐ More than one activity for at-risk purposes*

23 ☐ More than one activity for passive activity purposes*

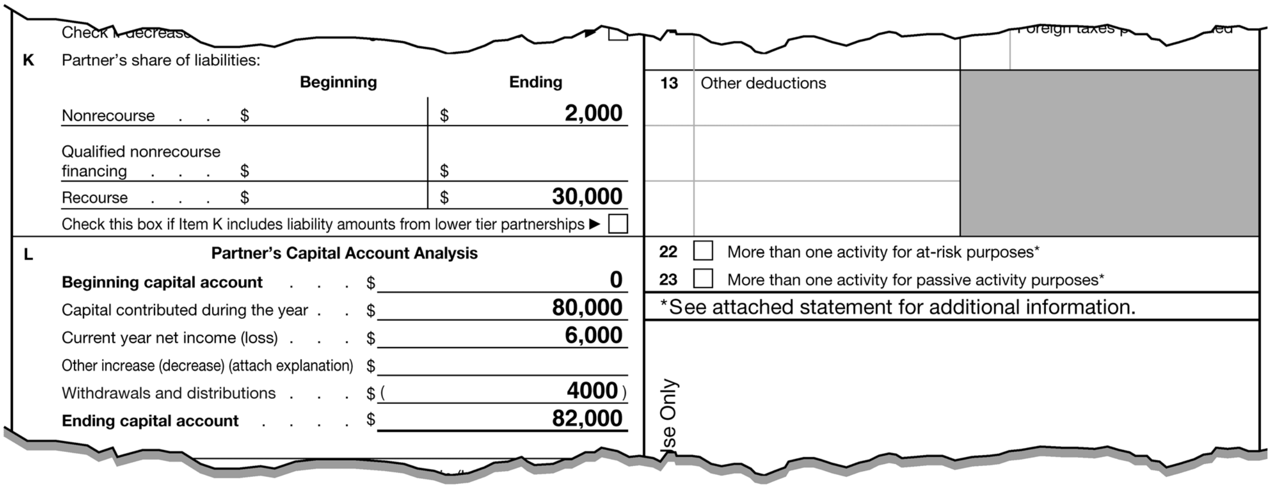
*See attached statement for additional information.

Use Only

Armed with this additional information, Cathy, Joanna's tax preparer, uses the IRS Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership, and determines that Joanna's revised December 31, 2021, tax basis in her partnership interest is **$84,000** calculated as follows.

Item	Amount	Information Source	IRS Worksheet Line No.
Adjusted basis of property contributed less liability assumed by the partnership ($100,000 − $20,000)	$80,000	Schedule K-1, part II, item L	2
Partnership liability assumed by partner	2,000	Schedule K-1, part II, item K	3
Current year income	6,000	Schedule K-1, part II, item L	4a
Withdrawals and distributions	(4,000)	Schedule K-1, part II, item L	7
Tax basis in partnership	$84,000		

Example 17. Use the same facts as in **Example 16,** except Joanna makes a $30,000 loan to the partnership. The entire $30,000 is allocated solely to Joanna as a recourse liability. This amount is reflected on the recourse line of her Schedule K-1.



K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$ 2,000
Qualified nonrecourse financing	$	$
Recourse	$	$ 30,000

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L Partner's Capital Account Analysis

Beginning capital account	$ 0
Capital contributed during the year	$ 80,000
Current year net income (loss)	$ 6,000
Other increase (decrease) (attach explanation)	$
Withdrawals and distributions	$ (4000)
Ending capital account	$ 82,000

13 Other deductions

22 ☐ More than one activity for at-risk purposes*

23 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

Cathy determines that Joanna's revised December 31, 2021, tax basis in her partnership interest is $114,000 calculated as follows.

Item	Amount	Information Source	IRS Worksheet Line No.
Adjusted basis of property contributed less liability assumed by the partnership ($100,000 − $20,000)	$ 80,000	Schedule K-1, part II, item L	2
Partnership liability assumed by partner	32,000	Schedule K-1, part II, item K	3
Current year income	6,000	Schedule K-1, part II, item L	4a
Withdrawals and distributions	(4,000)	Schedule K-1, part II, item L	7
Tax basis in partnership	$114,000		

OTHER PARTNER BASIS ADJUSTMENTS

Depletion Adjustments[138]

Partner tax basis is **increased** by the excess of the deductions for depletion (other than oil and gas depletion) over the basis of the property subject to depletion (line 6 of IRS Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership).

Partner tax basis is **decreased** (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the partner's share of the adjusted basis of such property (line 11 of IRS Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership).

138. See IRC §705.

Business Interest Expense Loss Limitation[139]

The business interest expense loss limitation rules only apply to business entities (including partnerships) that are **not** small businesses. For this purpose, a small business is one that is **not** a tax shelter **and** meets the gross receipts test. A taxpayer meets the gross receipts test[140] if the taxpayer has average annual gross receipts of $26 million or less for the last three tax years.[141]

Business taxpayers who are affected by the business interest expense loss limitation rules should consult the note at the foot of the IRS Worksheet for Adjusting the Basis of a Partner's Interest in the Partnership regarding appropriate partner basis adjustments.

OTHER ISSUES[142]

NEW SCHEDULES K-2 AND K-3[143]

Effective for tax years beginning in 2021, PTEs (including partnerships) with international items must now also complete Schedules K-2, *Partners' Distributive Share Items — International,* and K-3, *Partner's Share of Income, Deductions, Credits, etc. — International.* These new schedules replace prior Schedule K-1 lines 16 and 20 and are intended to provide greater clarity to partners regarding items of international tax relevance, including claiming foreign tax deductions and credits.

Note. See the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments, for in-depth coverage of these new tax reporting schedules.

IRS AUDITS OF PARTNERSHIP RETURNS[144]

According to IRS statistics, roughly 4 million partnership returns were filed in 2018 (the latest year's information available). Of these, 1,335 were audited (roughly 0.03%).

To help address this low audit rate, the IRS launched their Large Partnership Compliance (LPC) program which will use data analytics to select large partnership returns for 2019 to audit. Between October 2020 and October 2021, the IRS added over 200 additional revenue agents with the necessary experience to assist in this work.

139. IRC §163(j).

140. IRC §448(c).

141. Instructions for Form 8990.

142. *Current developments in partners and partnerships*. Burton, Hughlene A. Feb. 1, 2022. The Tax Adviser. [www.thetaxadviser.com/issues/2022/feb/current-developments-partners-partnerships.html] Accessed on May 13, 2022.

143. *Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865)*. Apr. 27, 2022. IRS. [www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865] Accessed on May 19, 2022; Instructions for Form 1065.

144. IRS Pub. 55-B, *Internal Revenue Service Data Book, 2020*; *IRS Launches Large Partnership Audits*. Armstrong, Greg; Borosh, Ossie; and Greenaway, Tom. Nov. 3, 2021. Bloomberg Tax. [news.bloombergtax.com/tax-insights-and-commentary/irs-launches-large-partnership-audits] Accessed on May 13, 2022.

Review of IRS Partnership Audits[145]

Since the beginning of 2018, the IRS has been examining partnership returns using the CPAR procedures[146] which in part replaced the previous procedures that were in place since the early 1980s.[147] The main impact of the new IRS partnership audit procedures was the switch from partner to **partnership** level for the assessment and collection of any understatement of tax, interest, and penalties. Partnerships with 100 or fewer partners can elect out of CPAR if all partners are eligible partners. Eligible partners are:

- Individuals
- C corporations
- Foreign entities that would be treated as C corporations if they were domestic
- S corporations
- Estates of deceased partners

The number of eligible partners is the number of Schedules K-1 the partnership is required to issue to partners **plus** all shareholders for any partner that is an S corporation.

> **Note.** Partnerships elect out of CPAR by checking the appropriate box on Schedule B, line 29 and completing Schedule B-2, *Electing Out of the Centralized Partnership Audit Regime*.

The IRS used CPAR procedures to conduct 480 examinations of returns for tax years 2016 through 2019. Of these 480 examinations, 376 (78%) were closed with **no change** which was high compared to the 50% no change rate for all partnership returns for the same tax years, closed as of September 30, 2020.

Due to this **high no-change** closure rate, the Treasury Inspector General for Tax Administration recommended that the IRS:

1. Address the high CPAR no-change rates,
2. Establish goals and measures that address the expected outcomes from the implementation of the CPAR, and
3. Implement a fully systemic method to monitor and verify that push-outs of partnership adjustments are properly reported on partners' returns.

The IRS agreed only to the third recommendation and will develop a systemic method to verify pushouts.

QBID[148]

Generally, for tax years through 2025, a partner is entitled to deduct 20% of their net QBI plus 20% of their qualified real estate investment trust dividends, and qualified PTP income from the partnership. To enable the partner to calculate their QBID, the **partnership is responsible for providing to the partner** the necessary information by reporting such information on Form 1065, Schedule K-1, box 20, code Z.

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145. TIGTA Report 2022-30-020 (Mar. 17, 2022).

146. See the *Bipartisan Budget Act of 2015,* PL 114-74, §1101; IRS Pub. 5388, *Bipartisan Budget Act (BBA) Roadmap for Taxpayers*.

147. See the *Tax Equity and Fiscal Responsibility Act of 1982,* PL-278.

148. IRC §199A.

When providing QBID information on the K-1, the partnership should consider the following questions and issues.

- Which of the partnership's trades or businesses qualify for the QBID?
- How much of the partnership's income from qualifying trades or businesses is QBI?
- Classification of QBI between ordinary business income (loss) and rental real estate income (loss)
- Identification of the partnership's specified service businesses
- Provision of QBI, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property for each of the partnership's trades or businesses
- Whether the partnership has made a business aggregation election[149]
- If deferring the business aggregation election to the partner, ensuring that the partner is provided with sufficient information to make this election

Note. For detailed information concerning the above questions/issues and other QBID-related information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues and the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

SELF-EMPLOYMENT ISSUES

Many new businesses are advised to become S corporations because of the self-employment (SE) tax liability imposed on partners. The tax regulations are very specific. If the partnership carries on a trade or business, a general partner must pay SE tax on their share of the income whether the income is distributed to them or not.[150] The regulations are less clear when the partner is a limited partner or the entity is an LLC taxed as a partnership.

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

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

LLC Taxed as a Partnership[151]

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

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

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

149. See Treas. Reg. §1.199A-4.

150. Treas. Reg. §1.1402(a)-1(a)(2).

151. Treas. Reg. §1.1402(a)-2(h).

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

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

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

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

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

Varying Interests in an LLC[152]

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

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

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

152. Ibid.

If an individual is not a limited partner solely because they participate in the entity's trade or business for more than 500 hours, they can still be treated as a limited partner (the holder of one class of interest rule for those that provide more than 500 hours of service). However, under either rule, such treatment is permitted only if the individual's distributive share is identical to the distributive shares of the partners who qualify as limited partners and who own **a substantial, continuing interest in the entity.** It might be more difficult under this approach to argue that earnings derived from an LLC that performs personal or professional services are not subject to SE tax. As a result, the proposed regulations state that if **substantially all** the activities of a partnership involve the **performance of professional services,** an individual member who provides those services is not considered a limited partner. For purposes of this exception, professional services include services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

Example 18. Angela, Barbra, and Connie form an LLC to engage in a business that does not provide services. The LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of the LLC to the three members in proportion to their ownership. Angela and Connie each contribute $1,000 for one LLC unit. Barbra contributes $2,000 for two LLC units. Each LLC unit entitles its holder to receive 25% of the LLC's tax items, including profits. Angela does not perform services for the LLC. Each year, Barbra receives a guaranteed payment of $6,000 for 600 hours of services rendered to the LLC. Connie receives a guaranteed payment of $10,000 for 1,000 hours of services rendered to the LLC. Connie is the LLC's manager. Under the applicable state's law, only Connie has the authority to contract on the LLC's behalf.

Angela is treated as a limited partner in the LLC because she is not personally liable for debts of, or claims against, the LLC. Angela does not have authority to contract for the LLC under state law, and she does not participate in the LLC's trade or business for more than 500 hours during the taxable year. Therefore, Angela's distributive share attributable to her LLC unit is excluded from SE net earnings.[153]

Barbra's treatment is more complex. She must use the varying interest rule to avoid SE tax. Unless she takes advantage of this rule, Barbra is **not** treated as a limited partner. As a result, Barbra's guaranteed payment of $6,000 is included in her SE net earnings under IRC §1402(a)(13).[154] Furthermore, Barbra is **not** treated as a limited partner with respect to other income flowing through to her on her Schedule K-1 because she participates in the LLC's trade or business for more than 500 hours during the taxable year.[155] As such, Barbra's distributive share would also be included in her SE net earnings.

However, by using the **varying interest rule,** Barbra **is** treated as a limited partner. This is because Angela, who is a limited partner under the regulations, owns a **substantial interest** with rights and obligations that are identical to Barbra's rights and obligations.[156] In this example, Barbra's distributive share is deemed a return on her investment in the LLC and not remuneration for any services she renders to the LLC. Therefore, Barbra's distributive share attributable to her two LLC units is not treated as SE net earnings §1402(a)(13).

Finally, Connie's guaranteed payment of $10,000 is included in her SE net earnings.[157] In addition, her distributive share attributable to her LLC unit is considered SE net earnings because she is **not** a limited partner. Connie is **not** treated as a limited partner because she has the authority under state law to enter into a binding contract on behalf of the LLC, and because she participates in the LLC's trade or business for more than 500 hours during the taxable year.[158] Furthermore, Connie is not treated as a limited partner because she does not hold more than one class of interest in the LLC. Consequently, both Connie's guaranteed payment and distributive share are included in her SE net earnings.

153. Treas. Reg. §1.1402(a)-2(i), Example (ii).

154. Treas. Reg. §1.1402(a)-2(i), Example (iii).

155. Treas. Reg. §1.1402(a)-2(h).

156. Ibid.

157. IRC §1402(a).

158. Treas. Reg. §1.1402(a)-2(h).

Observation. The approach taken by this latest set of proposed regulations is to exclude from an individual's SE tax those amounts that are demonstrably returns on capital invested in a partnership or LLC (much like the Schedule K-1 distributions to the S corporation owner, especially when reasonable compensation is not an issue).

Effective Dates

The proposed regulations were **never** adopted. In the 1997 Budget Reconciliation Act, the Senate expressed its displeasure with the proposed regulations defining limited partners. It stated that this task should be accomplished by the legislature. The conference committee directed the IRS not to issue any regulations on this matter before July 1, 1998.[159] There were two bills introduced in 2002 to modernize the Code to explicitly deal with LLC members. However, neither of these was enacted.

Note. LLC operating agreements should be reviewed and possibly modified to take advantage of the varying interest rule. In this regard, the examples in the previous section should be carefully studied for possibly avoiding SE tax, even for managing members of LLCs that do not provide services.

Caution. The IRS routinely rejects the argument that LLC members should not be subject to SE tax just because of the failure to finalized the regulations. The courts have imposed SE tax on LLC members unless, like traditional limited partners, they lack management authority and do not provide significant services to the business.[160]

159. §734 of the Senate amendment to H.R. 2014.

160. See, for example, *Renkemeyer, Campbell, and Weaver, LLP v. Comm'r,* 136 TC Memo 137 (2011); *Reither v. U.S.,* 919 F. Supp. 2d 1140 (D.N.C. 2012); *Castigliola v. Comm'r.,* TC Memo 2017-62 (2017).