

Chapter 4: Select Topics for Partnership Operations

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Note. Corrections were made to this workbook through January of 2024. 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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Other chapter contributors and reviewers are listed at the front of this book.

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This chapter builds upon the “Partnership Basics” chapter in the 2022 *University of Illinois Federal Tax Workbook* by examining certain specialized aspects of partnerships. This chapter intentionally omits any discussion of the termination or winding up of partnerships, which will be the subject of a future chapter.

Note. For purposes of this chapter, assume a limited liability company (LLC) is a multi-member LLC (MMLLC) being taxed as a partnership. An MMLLC may elect to be taxed as a C corporation or an S corporation. For more information on these “check the box” rules, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Partnership Basics.

Note. In the partnership taxation realm, there are three types of capital accounts.

1. **Tax basis**, which reflects the partners’ adjusted inside tax basis in the entity
2. **Book basis** (IRC §704(b)), which reflects fair market value (FMV) of assets and related adjustments
3. **Generally accepted accounting principles (GAAP) or other financial reporting basis**, which reflects the partnership’s activity as reported in its financial statements

For purposes of this chapter, references to capital accounts represent book basis. Tax basis is distinguished with “tax” preceding capital accounts, which generally reflects adjusted basis. Unless explicitly identified, GAAP or other financial reporting basis is not discussed in this chapter.

PARTNERSHIP AGREEMENT

A partnership is governed by the statutes of the state in which the partnership is organized. The partnership’s operating agreement,¹ if such an agreement exists, allows the partners to contract among themselves — for example, allowing guaranteed payments to one or more partners in addition to year-end distributions. A partnership agreement includes the original agreement and any modifications agreed to by all the partners or adopted in any other manner provided by the partnership agreement.² The agreement can be written or oral, depending on the applicable state law.³ State or local law governs in any matters where the partnership agreement is silent.⁴

Note. A tax return preparer should review the partnership agreement each year because the agreement is the contract between the partners that affects their respective capital accounts and interests through the classification of expenses, the allocation of income and expenses, and other agreed upon provisions. It is important to ensure that the partners are continuing to operate in accordance with their partnership agreement.

In particular, a preparer should examine the partnership agreement for the following items.

- Members and their interests
- Types of contributions made by each partner
- Partners’ distributive shares, special allocations, any guaranteed payments, health or other benefits
- Consistency of the partnership agreement with the partners’ understanding of the entity and their expectations
- Provisions of applicable state law for tax matters, such as its provisions for allocations, distributions, liquidations, etc., which become significant if the partnership agreement does not exist or is silent

¹. A partnership’s operating agreement may also be referred to as a partnership agreement.

². IRC §761(c).

³. Treas. Reg. §1.761-1(c).

⁴. Ibid.



Practitioner Planning Tip

During a review of partnership agreements, a tax practitioner may become aware of deficiencies in the partnership agreement. Rather than attempt to fix the agreement themselves, they should build relationships with local attorneys who are knowledgeable about partnership law. Unless the tax practitioner is a licensed attorney with partnership law expertise, involving a competent attorney to guide the client in partnership legal and tax matters serves the client's interests better.

CAPITAL ACCOUNTING

For income tax purposes, partnerships have a dual personality: for some purposes they are treated as separate entities from their partners under the **entity theory** of partnership taxation.⁵ For other purposes, they are treated as individual taxpayers engaging in a common activity.⁶ This is referred to as the **aggregate theory** of partnership taxation.⁷ This increases the complexity of partnership tax rules, which must reconcile the interests of partners with those of the partnership. These interests sometimes conflict. A good example of this is the IRC §754 election that allows inside basis adjustments of partnership assets with respect to outside occurrences affecting individual partners.

It is, therefore, necessary to have some benchmark by which the interactions of partner and partnership transactions can be measured to promote uniformity in the application of subchapter K to partnerships and their partners. One of these benchmarks is the capital account of each partner.

For purposes of Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, reporting, the IRS now mandates **tax basis capital accounts**.⁸ The capital account analysis is reported in box L of Schedule K-1 (Form 1065) as follows.

L Partner's Capital Account Analysis	
Beginning capital account	\$ _____
Capital contributed during the year	\$ _____
Current year net income (loss)	\$ _____
Other increase (decrease) (attach explanation)	\$ _____
Withdrawals and distributions	\$ (_____)
Ending capital account	\$ _____

Contribute property with a built-in gain (loss)?

⁵ See the 1954 *Conference Report on Section 707*: H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954).

⁶ IRC §701.

⁷ See, e.g., *Holiday Village Shopping Center, Inc. v. U.S.*, 773 F.2d 276 (Fed. Cir. 1985).

⁸ IRC §722; IRS Notice 2019-66, 2019-52 IRB 1509; IRS Notice 2020-43, 2020-27 IRB 1; IRS Notice 2021-13, 2021-06 IRB 832.

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This replaces optional methods of determining capital accounts on Schedules K-1 because their lack of uniformity frustrated the IRS's efforts to use them for compliance purposes. However, nothing prevents a partnership from simultaneously employing a separate capital accounting using traditional §704(b) rules or GAAP. In fact, the §704(b) rules are very relevant for partnerships with partners who have contributed property with book-tax disparities or partnerships that have special allocations, as discussed later. The following materials, therefore, discuss both tax basis capital accounting and §704(b) capital accounting.

TAX BASIS CAPITAL ACCOUNTS

The IRS has never explained why it requires tax basis capital account reporting. The consensus, however, is that the information provided by the capital account analysis did not permit the IRS to determine such things as partners not recognizing gain when disposing of partnership interests with negative capital accounts. Real estate limited partnerships that have nonrecourse financing are prone to this issue. Limited partners can use qualified nonrecourse financing as basis that enables them to take deductions — especially depreciation or equity-based distributions — in excess of their economic investments, resulting in negative capital accounts. Yet, if an individual disposes of a partnership interest, the IRS is concerned that the income tax consequences of those negative capital accounts too often go unreported.⁹ Requiring uniformity in capital accounts reporting is potentially a tool enabling the IRS to better identify failures to report tax consequences of such things as negative capital accounts and distributions in excess of basis.¹⁰

Partners' tax basis capital accounts must be prepared using the **transactional method** as described in the instructions for Form 1065, *U.S. Return of Partnership Income*. The use of any other method is prohibited.¹¹ There is, however, a "small" partnership exception. Under this, if a partnership satisfies all four of the following conditions, it is exempt from completing the balance sheet at Schedule L, *Balance Sheets per Books*, Schedules M-1, *Reconciliation of Income (Loss) per Books with Analysis of Net Income (Loss) per Return*, and M-2, *Analysis of Partners' Capital Accounts*. The partnership is not required to report negative tax basis capital account information.¹²

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*.

⁹ Treas. Reg. §1.704-1(b)(2)(ii)(b)(3).

¹⁰ *Partnerships: Audit Technique Guide*, p. 7-5. Sep. 2002. IRS. [www.unclefed.com/SurviveIRS/MSSP/partnershipsatg12-16.pdf] Accessed on Apr. 11, 2023.

¹¹ IRS Notice 2021-13, 2021-06 IRB 832.

¹² See Form 1065, Schedule B, *Other Information*, question 4.

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Schedules M-1 and M-2 for Form 1065 are shown below.

4

22	Total liabilities
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Schedule M-1 Reconciliation of Income (Loss) per Books With Analysis of Net Income (Loss) per Return
Note: The partnership may be required to file Schedule M-3. See instructions.

<table style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%; text-align: center;">1</td><td>Net income (loss) per books</td><td style="width: 45%;"></td></tr> <tr><td style="text-align: center;">2</td><td>Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):</td><td></td></tr> <tr><td style="text-align: center;">3</td><td>Guaranteed payments (other than health insurance)</td><td></td></tr> <tr><td style="text-align: center;">4</td><td>Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 21 (itemize):</td><td></td></tr> <tr><td style="text-align: center;">a</td><td>Depreciation \$</td><td></td></tr> <tr><td style="text-align: center;">b</td><td>Travel and entertainment \$</td><td></td></tr> <tr><td style="text-align: center;">5</td><td>Add lines 1 through 4</td><td></td></tr> </table>	1	Net income (loss) per books		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)		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 \$		5	Add lines 1 through 4		<table style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%; text-align: center;">6</td><td>Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):</td><td style="width: 45%;"></td></tr> <tr><td style="text-align: center;">a</td><td>Tax-exempt interest \$</td><td></td></tr> <tr><td style="text-align: center;">7</td><td>Deductions included on Schedule K, lines 1 through 13d, and 21, not charged against book income this year (itemize):</td><td></td></tr> <tr><td style="text-align: center;">a</td><td>Depreciation \$</td><td></td></tr> <tr><td style="text-align: center;">8</td><td>Add lines 6 and 7</td><td></td></tr> <tr><td style="text-align: center;">9</td><td>Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5</td><td></td></tr> </table>	6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):		a	Tax-exempt interest \$		7	Deductions included on Schedule K, lines 1 through 13d, and 21, not charged against book income this year (itemize):		a	Depreciation \$		8	Add lines 6 and 7		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	
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Schedule M-2 Analysis of Partners' Capital Accounts

<table style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%; text-align: center;">1</td><td>Balance at beginning of year</td><td style="width: 45%;"></td></tr> <tr><td style="text-align: center;">2</td><td>Capital contributed: a Cash</td><td></td></tr> <tr><td></td><td>b Property</td><td></td></tr> <tr><td style="text-align: center;">3</td><td>Net income (loss) (see instructions)</td><td></td></tr> <tr><td style="text-align: center;">4</td><td>Other increases (itemize):</td><td></td></tr> <tr><td style="text-align: center;">5</td><td>Add lines 1 through 4</td><td></td></tr> </table>	1	Balance at beginning of year		2	Capital contributed: a Cash			b Property		3	Net income (loss) (see instructions)		4	Other increases (itemize):		5	Add lines 1 through 4		<table style="width: 100%; border-collapse: collapse;"> <tr><td style="width: 5%; text-align: center;">6</td><td>Distributions: a Cash</td><td style="width: 45%;"></td></tr> <tr><td></td><td>b Property</td><td></td></tr> <tr><td style="text-align: center;">7</td><td>Other decreases (itemize):</td><td></td></tr> <tr><td style="text-align: center;">8</td><td>Add lines 6 and 7</td><td></td></tr> <tr><td style="text-align: center;">9</td><td>Balance at end of year. Subtract line 8 from line 5</td><td></td></tr> </table>	6	Distributions: a Cash			b Property		7	Other decreases (itemize):		8	Add lines 6 and 7		9	Balance at end of year. Subtract line 8 from line 5	
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Form **1065** (2022)



Practitioner Planning Tip

Although the partnership is not required to complete Schedules L, M-1, and M-2 under these conditions, the information contained in these schedules may be necessary in the future to properly prepare returns.

Reporting Transactions

Tax basis capital accounts are determined each year using the following adjustments.¹³

	Tax Basis Capital
Beginning capital account	\$
Capital contributed during the year	\$
Current year net income (loss)	\$
Other increase (decrease) (attach explanation)	\$
Withdrawals and distributions	\$ ()
Ending capital account	\$

¹³ Instructions for Form 1065.

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Capital Contributions.¹⁴ For tax basis capital account purposes, capital contributed includes the amount of cash plus the **adjusted tax basis** of all property contributed by the partner to the partnership during the year. The amount entered on this line must be reduced by any liabilities assumed by the partnership in connection with the contribution or liabilities to which the property is subject immediately before the contribution. This amount might be negative, such as a transfer of property subject to liabilities in excess of the contributing partner's basis in the property.

Current Year Income or Loss. This line is the partner's distributive share of partnership income and gain (including tax-exempt income) for the year as determined for tax purposes, minus the partner's distributive share of partnership loss and deductions (including nondeductible, noncapital expenditures) as determined for tax purposes.

Other Increases and Decreases.¹⁵ This line is the sum of all other increases or decreases that affected the partner's capital account for tax purposes during the year. A statement must be attached to Form 1065 explaining each adjustment. The 2022 Form 1065 instructions give the following examples of increases and decreases that should be reported on this line.

Increases	Decreases
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, but not exceeding the partner's share of the adjusted tax basis of that property.
The partner's share of any increase to the adjusted tax basis of partnership property under IRC §734(b).	The partner's share of any decrease to the adjusted tax basis of partnership property under §734(b).

In the event of uncertainty on how to report a partnership event or transaction, the instructions say to account for it in a manner generally consistent with determining the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the following rules and principles.

IRC §705. This section deals generally with how annual basis adjustments are made to a partner's basis in its partnership interest and will also affect the tax basis capital account. Basis is increased by:¹⁶

1. Additional contributions of cash and basis of property contributed to the partnership and allocation of partnership liabilities;
2. The partner's distributive share of non-separately computed and separately stated income;
3. The partner's distributive share of partnership tax-exempt income; and
4. The partner's distributive share of the excess of the deductions for depletion in excess of the partnership's basis for the depletable property.

Basis is decreased, but not below zero, by:¹⁷

1. The amount of money and the adjusted basis of property distributed to the partner by the partnership, including money attributable to a partner's reduction in partnership liabilities allocated to the partner;
2. The partner's distributive share of separately and non-separately stated partnership losses, including capital losses;
3. The partner's distributive share of nondeductible partnership expenses that are not capital expenditures; and
4. The amount of the partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the partnership's adjusted basis for its depletable properties.

¹⁴ IRS Notice 2020-43, 2020-27 IRB 1.

¹⁵ 2022 Instructions for Form 1065.

¹⁶ IRC §705(a); Treas. Regs. §§1.705-1 and 1.705-2.

¹⁷ IRC §§705(a)(2) and (3).

IRC §722. This section states that the basis of a partner's interest in the partnership is the amount of money and adjusted basis of property contributed by the partner, increased by any gain required to be recognized under IRC §721(b) if the partnership is treated as an investment company.

IRC §733. This section deals with the effect of nonliquidating distributions on a partner's basis of its partnership interest. It requires that the partner's basis be reduced (but not below zero) by the sum of any money distributed and the partnership's adjusted basis of any property distributed (but not in excess of the partner's adjusted basis in its partnership interest after reduction by any money distributed).

IRC §742. Under this section, the basis of a partner's partnership interest acquired other than by contribution to the partnership is to be determined under the usual basis rules beginning at IRC §1011. This includes, for example, such things as FMV inherited basis under IRC §1014 and carryover gift basis under IRC §1015.

Withdrawals and Distributions. This line should have the amount of cash plus the adjusted tax basis of all property distributed by the partnership to the partner during the year. The amount entered must be reduced by any liabilities assumed by the partner in connection with the distribution or liabilities to which the property was subject immediately before the distribution. This amount may be negative.

Ending Capital Account. The sum of the amounts previously discussed from the chart constitute the partner's ending capital account, which may be negative if the sum of a partner's losses and distributions exceeds the sum of the partner's contributions and share of income.

Observation. Prohibiting the use of liabilities in determining tax basis **capital** accounts tends to portray a more realistic picture of a partner's actual economic relationship with the partnership. This is especially true with respect to real estate partnerships where deductions and distributions attributable to nonrecourse debt can easily exceed a partner's economic investment.

IRC §704(b) CAPITAL ACCOUNTS

Traditional capital accounting under §704(b) is used to measure a partner's **economic investment** in a partnership as opposed to its **tax investment**. **Capital accounts are commonly referred to as “book” accounts** to distinguish them from tax capital accounts. The principal difference between the two is that book capital accounts are based on the FMV of contributed assets,¹⁸ while tax capital accounts use the adjusted tax basis of contributed assets.¹⁹ In this section, the term “capital account” refers to “book” unless stated otherwise. Tax basis capital accounts are discussed previously.

Although the maintenance of capital accounts is intended to track the partners' economic interests in a partnership, these accounts are generally adjusted with respect to tax items, rather than through the use of normal financial accounting rules. This is because the fundamental rule of partnership allocations is that tax allocations must follow book allocations.²⁰ In this context “following book” establishes the standard by which special allocations are measured: an allocation that has a tax effect without also affecting the economic circumstances of a partner may be disregarded.

Note. In addition, special rules are provided under §704(c) (described in the section titled “IRC §704(c) Allocations”) for contributions of property with a book value that differs from its tax basis (referred to as **book-tax disparities**) because, in these instances, tax allocations and book allocations necessarily differ. Information concerning contributions to a partnership of §704(c) assets by a partner and mandatory allocations of items with respect to such property are reportable on partners' Schedules K-1.

¹⁸ See Treas. Regs. §1.704-1(b)(2)(iv)(b) and 1.704-1(b)(2)(iv)(g).

¹⁹ IRC §722.

²⁰ Treas. Reg. §1.704-1(b)(2)(ii).

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Each partner's book capital account begins at zero and, in general, is **increased** by the following items.²¹

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

The following items **decrease** book capital accounts.²²

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

A partner who has more than one interest in a partnership is required to have a single book capital account that combines all interests of the partner in the partnership.²³

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

Liabilities²⁴

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

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

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

FMV²⁵

The FMV assigned to property by the partners is generally accepted for book purposes if the value is reasonably agreed to among the partners in arm's-length negotiations and the partners have sufficiently adverse interests. If these conditions are not satisfied and the property values are overstated or understated by more than an insignificant amount, the partners' capital accounts are not considered to satisfy the economic effect requirement (other than economic equivalence).²⁶ FMV is determined without taking into account the IRC §7701(g) requirement that the FMV of property securing a nonrecourse liability is not treated as less than the amount of the nonrecourse liability.

²¹ Treas. Reg. §1.704-1(b)(2)(iv)(b).

²² Ibid.

²³ Ibid.

²⁴ Treas. Reg. §1.704-1(b)(2)(iv)(c).

²⁵ Treas. Reg. §1.704-1(b)(2)(iv)(h)(1).

²⁶ Ibid.

Promissory Notes

A partner's contribution of a promissory note does not result in any increase in the partner's book account unless the partnership disposes of the note in a taxable transaction or payments are actually made against the note principal by the contributing partner.²⁷ If the note is readily tradable on an established securities market, however, this limitation is not applicable.²⁸ Similarly, a partner's capital account is not decreased for distribution of a partnership's note to a partner unless there is a taxable disposition of the note by the partner or the partnership makes principal payments.²⁹

IRC §704(c) Considerations

The partnership agreement must require that the partners' capital accounts be adjusted to reflect differences between book value and tax basis with respect to contributed property subject to a §704(c) special allocation for precontribution gain or loss.³⁰ The capital accounts **are not adjusted**, however, to reflect the actual tax allocations required under §704(c).³¹

Note. A partner's share of net unrecognized §704(c) gain or loss can be reported on their Schedule K-1 in Part II, item N.³²

Distributed Property

A partner's capital account is decreased by the FMV of property distributed to the partner. In doing so, the capital accounts of all the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in the property that has not previously been reflected in capital accounts would be allocated among the partners if there were a taxable disposition of the property for its FMV.³³ For this purpose, the excess of nonrecourse liabilities over FMV is taken into account.³⁴

Revaluations of Partnership Property

A partnership agreement may increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books, including intangible assets such as goodwill.³⁵ For revaluations to be acceptable, they must be made principally for a substantial nontax business purpose such as any of the following.³⁶

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

²⁷ Treas. Reg. §1.704-1(b)(2)(iv)(d)(2).

²⁸ Ibid.

²⁹ Treas. Reg. §1.704-1(b)(2)(iv)(e)(2).

³⁰ Treas. Reg. §1.704-1(b)(2)(iv)(d)(3).

³¹ Ibid.

³² 2022 Instructions for Form 1065; See IRS Notice 2019-66, 2019-52 IRB 1510.

³³ Treas. Reg. §1.704-1(b)(2)(iv)(e)(1).

³⁴ Ibid.

³⁵ Treas. Reg. §1.704-1(b)(2)(iv)(f).

³⁶ Treas. Regs. §§1.704-1(b)(2)(iv)(f)(5)(i)-(v).

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In addition, the partnership agreement must generally require that the capital accounts be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in the property would be allocated among the partners under §704(c) special allocation principles if there were a taxable disposition of the property for FMV on the date of distribution.³⁷

Special Adjustments to Reflect Book Values

One of the goals of the **substantial economic effect test** (discussed later) is to apply economic rules to a partnership's bookkeeping that, over time, eliminate the differences between the partnership's tax values (basis) and its book values (FMV). This is also a purpose of the mandatory §704(c) special allocations with respect to precontribution gain or loss. Allocations to the partners of depreciation, depletion, amortization, and gain or loss for book purposes must, therefore, be made for the book value of the property using the same ratio as the corresponding tax item over the tax basis of the property.³⁸ For depreciation and other amortization purposes, if the property has a zero tax basis, the corresponding book deduction may be determined under any reasonable method selected by the partnership.³⁹

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

Nondeductible Expenditures⁴⁰

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

Depletion

Depletion deductions are separately stated items for income tax purposes. For book accounting, however, the regulations require that "simulated" depletion be determined at the partnership level and be used to adjust book value without regard to the tax limitations that apply at the individual partner level. Alternatively, each partner's actual depletion deduction can be used.⁴¹

Transfers of Partnership Interest

Upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest must carry over to the transferee-partner.⁴² Prior to the Tax Cuts and Jobs Act (TCJA), the provisions of IRC §708 could cause technical terminations of partnerships. The TCJA nullified these provisions, enabling partnerships to continue even if more than 50% of the capital interests changed within a 12-month period.

Under current law, if two partnerships merge, the book capital accounts of the two entities are combined. The Code considers the resulting partnership to be the continuation of the partnership whose partners held more than 50% of the capital in the new, combined partnership. The book capital accounts of the successor entity consist of the merged book capital accounts of each merged partnership.⁴³ Conversely, if a partnership divides into multiple partnerships, the Code considers each a continuation of the prior partnership.⁴⁴

³⁷ Treas. Regs. §§1.704-1(b)(2)(iv)(f)(1)–(4).

³⁸ Treas. Regs. §§1.704-1(b)(2)(iv)(g)(1) and (3).

³⁹ Treas. Reg. §1.704-1(b)(2)(iv)(g)(3).

⁴⁰ Treas. Reg. §1.704-1(b)(2)(iv)(i).

⁴¹ Treas. Reg. §1.704-1(b)(2)(iv)(k).

⁴² Treas. Reg. §1.704-1(b)(2)(iv)(l).

⁴³ IRC §708(b)(2)(A).

⁴⁴ IRC §708(b)(2)(B).

Optional Basis Adjustments

A partnership that has a §754 election in effect is generally not permitted to adjust the book account of a transferee-partner or of the partnership in the case of an IRC §743 adjustment under which a transferee-partner adjusts the partner's share of inside tax basis to reflect the outside tax basis.⁴⁵ This does not apply, however, to the extent the basis adjustment is allocated to the common basis of partnership property.⁴⁶ IRC §732(d) adjustments for partnerships that do not have a §754 election in effect are treated in the same manner.⁴⁷

If there is an adjustment under §734 (discussed later) as a result of gain or loss being recognized by a distributee-partner upon distribution of property from the partnership, the partner receiving the distribution giving rise to the adjustment is required to have a corresponding adjustment made to their book account.⁴⁸ If the distribution is made other than in liquidation of the partner's interest, however, the capital accounts of all partners are adjusted. The adjustment should be made in the manner in which the unrealized income and gain that is displaced by the adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to the adjustment for its recomputed adjusted tax basis.⁴⁹

A partner's capital account may be adjusted for §§732, 734, and 743 basis adjustments to partnership property but only to the extent that such basis adjustments are permitted to partnership property under IRC §755 and result in a change in the amount for such property on the partnership's balance sheet for book purposes.⁵⁰

Partnership Level Characterization

Except as otherwise required for depletion, the book capital accounts of partners must be determined by applying federal tax rules at the partnership level without regard to how items would be required to be treated at the individual partner level. In other words, book accounting treats the partnership as an entity rather than as an aggregate.⁵¹

Capital Accounts and Guaranteed Payments

Guaranteed payments to a partner under §707(c) cause the capital account of the recipient partner to be adjusted only to the extent of the partner's distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.⁵²

Minor Discrepancies

Minor discrepancies between the actual balances in the capital accounts of the partners and the balances that would have existed had the book accounting rules been properly followed are not treated as violating the substantial economic effect requirement as long as they are attributable to good faith error by the partnership.⁵³

⁴⁵ Treas. Reg. §1.704-1(b)(2)(iv)(m)(2).

⁴⁶ Ibid.

⁴⁷ Treas. Reg. §1.704-1(b)(2)(iv)(m)(3).

⁴⁸ Treas. Reg. §1.704-1(b)(2)(iv)(m)(4).

⁴⁹ Ibid.

⁵⁰ Treas. Reg. §1.704-1(b)(2)(iv)(m)(5).

⁵¹ Treas. Reg. §1.704-1(b)(2)(iv)(n).

⁵² Treas. Reg. §1.704-1(b)(2)(iv)(o).

⁵³ Treas. Reg. §1.704-1(b)(2)(iv)(p).

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Adjustments When Guidance Is Lacking

If the regulations fail to provide guidance on how adjustments to capital accounts should be made with respect to particular items, then adjustments must be made in a manner that:⁵⁴

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

IRC §704(c) ALLOCATIONS

The purpose of §704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain, loss, income, or deductions. Under §704(c), therefore, a partnership **must** allocate back to the contributing partner any precontribution income, gain, loss, and deductions with respect to property contributed by the partner to the partnership to the extent of any difference between the adjusted tax basis of the property and its FMV at the time of contribution. This is commonly referred to as **book-tax disparity** because the contributing partner's capital account is credited with the FMV of the property, while the partner's partnership basis attributable to the contributed property uses the property's adjusted basis. Such special allocations must be made using a reasonable method that is consistent with the purpose of §704(c). These allocations are **mandatory**, whether contained in the partnership agreement or not.

Built-in gain on §704(c) property (more common than built-in loss) is the excess of the property's book (fair market) value over the contributing partner's tax basis in their partnership interest upon contribution. The built-in gain is thereafter reduced by decreases in the gap between the property's book value and adjusted tax basis. Built-in loss on §704(c) property is the excess of the contributing partner's basis over the property's book value upon contribution. The built-in loss is thereafter reduced by decreases in the gap between the property's adjusted tax basis and book value.⁵⁵ If the property is sold, the built-in gain or loss as of the sale date must be specially allocated back to the contributing partner and only gain or loss in excess of that is divisible among all partners.

Note. Allocation of built-in gain or loss to a partner will increase or decrease their **basis** in their partnership interest, but there will be **no adjustment to their capital account** because the built-in gain or loss for capital account purposes is already reflected in determining the initial capital account value of the contributed property.

⁵⁴ Treas. Reg. §1.704-1(b)(2)(iv)(q).

⁵⁵ Treas. Reg. §1.704-3(a)(3)(ii).

Example 2. In exchange for a 50% interest in a new partnership, Amos contributes fully depreciated property with a FMV of \$100 and an adjusted basis of \$0. The property, therefore, has \$100 of §704(c) built-in gain because Amos' capital account is \$100, the property's FMV, but his partnership basis is zero, the contributed property's adjusted basis. There are five years remaining in the depreciable period. Beatrice, the other partner, contributes \$100 of cash and therefore has no book-tax disparity because both her capital account and her partnership basis are \$100. The partnership agreement provides that all allocations are 50-50.

Under the simplest approach to §704(c), if the property is sold for \$150, Amos is allocated the first \$100 of gain. This eliminates the book-tax disparity because his partnership basis increases to \$100. His capital account, however, is not increased by the \$100 of gain (normally it would be) because that \$100 is already represented by the \$100 FMV of the property based on its precontribution gain. The remaining \$50 of gain is then allocated equally between the two partners under §704(b) (the usual partnership allocation rules). Therefore, Amos is allocated a total of \$125 of the \$150 of gain, and Beatrice is allocated \$25, which is her 50% share of the \$50 of post-contribution gain in excess of the §704(c) \$100 of built-in gain allocated to Amos.

Thus, in the end, each partner will have a capital account of \$125 and a partnership basis of \$125. The partnership will have \$250 cash. If the cash is distributed to the partners in the liquidation of the partnership, each will receive \$125 of cash against their \$125 of basis so that liquidating distributions are nontaxable.

Failure to account for and properly apply the §704(c) rules is not just a violation of rules and regulations, it can actually have an economic impact on partners, as demonstrated by the following example.

Example 3. Use the same facts as in **Example 2**, except that, when the property is sold, §704(c) is not taken into account. As a result, the entire \$150 of gain is divided equally between Amos and Beatrice, with each reporting \$75 of gain. Each partner's capital account increases by \$75, so that each has a \$175 capital account. Similarly, their respective partnership bases increase by \$75, so that Amos will have \$75 of basis and Beatrice \$175.

If the partnership then distributes its assets 50-50 in liquidation, each partner receives \$125 of cash. Amos has \$50 of capital gain because the \$125 of cash distributed exceeds his \$75 of partnership basis. Beatrice has a \$50 capital loss because the \$125 of cash distributed to her is less than her \$175 basis.

Amos's \$50 capital gain represents half of the \$100 built-in gain he should have recognized under §704(c). The \$50 of capital loss for Beatrice represents the other \$50 of built-in gain, the tax on which should have been paid by Amos but was instead paid by Beatrice. Thus, on a present value basis, Amos has a tax windfall by deferring paying tax on \$50 (half the built-in gain) until the liquidation of the partnership. Beatrice suffers a tax detriment because she has paid income tax on \$50 of gain that is actually not her income and does not recover that prepayment until liquidation of the partnership. This distortion would be even worse if the \$100 were ordinary income, such as depreciation recapture. In that case, Amos would effectively convert \$50 of ordinary income to long-term capital gain, and Beatrice would convert \$50 of ordinary income to a long-term capital loss.

Caution. Beatrice is likely to be very unhappy with her tax returns. A situation like this could be considered preparer malpractice.

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The problem is more complicated, however, than simply waiting until the property is disposed of to allocate the built-in gain. Instead, the §704(c) regulations **mandate** that the book-tax disparity be eliminated as quickly as possible. “Elimination” means that adjustments must be made that will, over time, cause all partners’ income tax bases to equal their capital accounts. This can be done through any reasonable method. Although no particular method is required by the Code or regulations, the regulations set out three methods that generally are considered reasonable (traditional method, traditional method with curative allocation, and remedial method).⁵⁶ The following is a very simplistic example of one method for correcting a book-tax disparity.⁵⁷

Example 4. Use the same facts as **Example 3**. Additionally, the \$100 of cash contributed by Beatrice is used to purchase depreciable property. Assume that the property is depreciated for both book and tax purposes at the rate of \$20 per year over five years (ignoring conventions). The two partners’ initial capital accounts and tax bases in the partnership are as follows.

Partner	Capital Account	Tax Basis
Amos	\$100	\$ 0
Beatrice	100	100

Amos has a book-tax disparity of \$100 because his capital account exceeds his partnership basis by that amount. Beatrice has no book-tax disparity, but in eliminating Amos’s disparity, adjustments are also made to Beatrice’s capital account and bases. In this case, that will be accomplished through special allocations of depreciation deductions for income tax purposes (**but not for capital account purposes**) that will, as soon and as much as possible, cause both partners to have capital accounts that equal their partnership tax bases. Thus, over the five years the property is depreciated, capital accounts and tax bases are adjusted as follows.

Year	Capital Account	Book Depreciation	Tax Basis	Tax Depreciation
Amos				
1	\$100	\$10	\$ 0	\$ 0
2	80	10	0	0
3	60	10	0	0
4	40	10	0	0
5	20	10	0	0
6	0	0	0	0
Beatrice				
1	\$100	\$10	\$100	\$20
2	80	10	80	20
3	60	10	60	20
4	40	10	40	20
5	20	10	20	20
6	0	0	0	0

Beginning in year six, the book-tax disparity has been eliminated. There is also no remaining depreciation to be allocated between the partners.

⁵⁶ Treas. Regs. §§1.704-3(b)–(d).

⁵⁷ This is the traditional method at Treas. Reg. §1.704-3(b).

⁵⁸ Partner’s Instructions for Schedule K-1 (Form 1065).

Observation. It is important to be able to recognize circumstances involving §704(c) assets because the existence of book-tax disparities has a significant effect on the proper maintenance of capital accounts and allocations of minimum gain under the nonrecourse debt rules. In addition, the 2022 Schedule K-1 (Form 1065), part II, item M, asks whether the partner contributed property with a built-in gain or loss. If so, the partnership must attach a statement showing the property contributed, the date of the contribution, and the amount of any built-in gain or loss. Subsequent special allocations under §704(c) must also be reported to the partner at line 20, “other information,” with a code AA. In any year that a partner is allocated any §704(c) gain or loss, the partnership must also show the net unrecognized §704(c) gain or loss at the beginning at the end of that year in item N.⁵⁸

GUARANTEED PAYMENTS

Partners who are working full time for the partnership generally cannot wait until after the end of the partnership’s tax year to receive their distributive share of partnership income. As a result, partners generally receive payments during the year. It is therefore necessary to determine the character of such payments and their income and employment tax effects. The IRS has ruled that partners are not employees of a partnership for employment tax purposes and that remuneration received by a partner from the partnership is not wages, a position it maintains today.⁵⁹ Under existing guidance, therefore, it is virtually impossible for a partner working in the partnership’s business to be treated as an employee of the partnership for either withholding or fringe benefit purposes except when the latter are expressly permitted in the Code, such as for certain pension purposes.

CHARACTERIZATION

In the partnership context, therefore, payments received by a partner during the year and before their distributive share for that year is determined can be one of three types: an advance draw, an interim distribution, or a guaranteed payment. With an **advance draw**, the partner is essentially borrowing against their end of the year distributive share. The draws are therefore not taxable when received because they are simply part of the partner’s distributive share determined as of the close of the partnership’s tax year.⁶⁰ If the payment is an **interim distribution**, it is taxable only to the extent it exceeds the partner’s basis in the partnership as of the distribution date.⁶¹ Finally, if the payment is a **guaranteed payment**, it is treated as self-employment (SE) income (if paid for services) to the recipient partner and is an expense of the partnership.⁶²

General partners must include guaranteed payments as SE net earnings. However, a limited partner must include in net earnings only those guaranteed payments for services rendered to, or on behalf of, the partnership.⁶³ If the purpose of the guaranteed payment is to provide a minimum return on capital, though, then the SE tax is not imposed.⁶⁴ SE tax arising from partnership activities is discussed later.

Determining which type of payment a partner has received may not be readily apparent, especially if not specifically addressed in the partnership agreement. Even then, however, the actual conduct of the parties may differ from the terms of the partnership agreement. In such cases, the determination becomes based on the facts and circumstances surrounding what the parties did and how that was done. However, in this regard there are a few rules of thumb based on the characteristics of each type of payment.⁶⁵

⁵⁹ Rev. Rul. 69-184, 1969-1 CB 256.

⁶⁰ IRC §704(b).

⁶¹ IRC §731.

⁶² IRC §707(c).

⁶³ IRC §1402; *Question: Are partners considered employees of a partnership or are they considered self-employed?* Sep. 6, 2022. IRS. [www.irs.gov/faqs/small-business-self-employed-other-business/entities/entities-1#] Accessed on Apr. 13, 2023.

⁶⁴ IRC §1402(a)(2).

⁶⁵ *Mangham v. Comm’r*; TC Memo 1980-280 (Jul. 29, 1980).

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ADVANCE

An advance against a partner's distributive share is effectively a loan. Therefore, if the partner's distributive share for the year is less than the sum of the advances, there must be an obligation for the partner to repay the excess.

Distributions are made from a partner's capital account and are nontaxable returns of capital only to the extent of the partner's basis. It may be somewhat more difficult to distinguish between distributions and guaranteed payments so that facts and circumstances must be more closely examined. In general, if the payments are made even though the partnership has a loss for the year and there is no proper capital accounting by the partnership, such payments may be found to be guaranteed payments.⁶⁶

Guaranteed payments are those made to a partner who is acting in a capacity other than as a partner.⁶⁷ There is no specific definition of what acting as "other than a partner" means; rather it is based on the parties' conduct. So long as it appears that a partner is entitled to particular payments (even if the amounts vary) without regard to the partnership's profit or loss and the partner's distributive share, it is likely to be a guaranteed payment.⁶⁸

Generally, the IRS has been willing to consider all facts and circumstances in differentiating between payments based directly on partnership income versus those based on a formula that references partnership income. However, the courts have been more stringent in finding that any payment linked to partnership income does not qualify as a guaranteed payment.⁶⁹ Thus, it may be easier to think of guaranteed payments as akin to arm's-length transactions with non-members of the partnership.

TAX IMPACTS

From the partnership perspective, guaranteed payments may be either:

- Deductible under IRC §162(a) as ordinary or necessary business expenses, or
- Capitalized under IRC §263.

"[A] partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc."⁷⁰ Thus, the partnership is not responsible for withholding employment taxes from guaranteed payments.⁷¹

From the recipient's perspective, the guaranteed payment is ordinary income solely for purposes of IRC §61 and is not a distributive share of partnership profits or payment to an employee that would entitle the recipient partner to employee benefits.⁷² The income should also be reported in the same taxable year as the partnership deducts the payment.⁷³

⁶⁶ *Clark v. Comm'r*, TC Memo 1982-401 (Jul. 19, 1982).

⁶⁷ IRC §707(a).

⁶⁸ *Ibid.*

⁶⁹ See *Pratt v. Comm'r*, 64 TC. 203, 210-211 (1975), finding that a partnership agreement guaranteeing each partner a management fee calculated as a fixed percentage of gross rental income did not meet the requirements of §707.

⁷⁰ Treas. Reg. §1.707-1(c).

⁷¹ Rev. Rul. 56-326, 1956-2 CB 501.

⁷² Treas. Reg. §1.707-1(c).

⁷³ *Ibid.*

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Example 5. ABC Partnership has three partners. All partnership items are allocated in accordance with the partners' percentage interests. The partners have the following ownership interests, tax bases, and capital accounts.

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

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

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

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

Example 6. Use the same facts as **Example 5**, except pursuant to the partnership agreement, Avery receives \$5,000 annually for her services, without regard to partnership income, plus 20% of the partnership's taxable gain or loss. The other 80% of partnership gain or loss is allocated between Basil and Carlita. Carlita receives no guaranteed payment. If the partnership has \$40,000 income after deducting the \$5,000 guaranteed payment to her, Avery reports \$13,000 of ordinary income comprised of the \$5,000 guaranteed payment and \$8,000 share of ABC's income ($20\% \times \$40,000$).⁷⁴

Guaranteed Payment	Allocated Partnership Gain/Loss	Reported Ordinary Income
\$5,000	$20\% \times \$40,000 = \$8,000$	\$13,000

Example 7. Use the same facts as **Example 5**, except pursuant to the partnership agreement, Basil receives 25% of the partnership's taxable gain or loss before taking into account any guaranteed payments, with a guaranteed minimum of \$20,000. Carlita receives no guaranteed payment. If the partnership's income is \$90,000, then Basil receives \$22,500 ($25\% \times \$90,000$) as his distributive share and no guaranteed payment.

(A) Guaranteed Minimum	(B) Allocated Partnership Gain/Loss	(A - B) Guaranteed Payment (Limited to \$0)	Distributive Share
\$20,000	$\$90,000 \times 25\% = \$22,500$	\$0	\$22,500

If the partnership's income is only \$60,000, then Basil receives \$15,000 ($25\% \times \$60,000$) as his distributive share and \$5,000 ($\$20,000 - \$15,000$) as a guaranteed payment.⁷⁵

(A) Guaranteed Minimum	(B) Allocated Partnership Gain/Loss	(A - B) Guaranteed Payment (Limited to \$0)	Distributive Share
\$20,000	$\$60,000 \times 25\% = \$15,000$	\$5,000	\$15,000

⁷⁴ Treas. Reg. §1.707-1(c). See example 1.

⁷⁵ Treas. Reg. §1.707-1(c). See example 2.

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Example 8. Use the same facts as **Example 5**, except pursuant to the partnership agreement, Carlita receives 30% of the partnership's taxable gain or loss, and a guaranteed payment of \$15,000 for services. If the partnership has a loss of \$6,000 after deducting the \$15,000 guaranteed payment, then Carlita reports the \$15,000 as ordinary income, and \$1,800 ($30\% \times \$6,000$) as a loss under §704(d).⁷⁶

Percentage	Guaranteed Payment	Allocated Partnership Loss	Reported Ordinary Income
30	\$15,000	$30\% \times \$6,000 = \$1,800$	\$15,000

Example 9. Use the same facts as **Example 5**, except pursuant to the partnership agreement, Carlita receives 30% of the partnership's taxable gain or loss, and a guaranteed payment of \$15,000 for services. If the partnership has only capital gains of \$30,000 prior to deducting the \$15,000 guaranteed payment, then Carlita reports the \$15,000 as ordinary income, \$4,500 ($30\% \times \$15,000$) of ordinary loss, and \$9,000 ($30\% \times \$30,000$) as a capital gain – all segregated per IRC §702(a).⁷⁷

Percentage	Guaranteed Payment	Allocated Partnership Loss (Ordinary)	Reported Ordinary Income	Reported Capital Gain
30	\$15,000	$30\% \times \$15,000 = \$4,500$	\$15,000	$30\% \times \$30,000 = \$9,000$

PROPERTY TRANSACTIONS

If a partner makes or receives a transfer of money or property with a partnership, and the transaction may be characterized as a sale or exchange of property (that is, not a contribution or distribution), then, under §707(a), the partner is treated as acting in a capacity other than as a member of the partnership.

If the partner directly or indirectly owns more than 50% of the capital interest or profits interest in the partnership, then the entity is considered a controlled entity.⁷⁸ The Code disallows losses between the partnership and the partner, even if the transaction is conducted through a second partnership in which the partner owns more than a 50% interest. However, if the transferee subsequently sells or exchanges the property for a gain, then the previously disallowed loss is allowed.⁷⁹

Example 10. Partners Dana, Edward, and Felicity own 30%, 30%, and 40%, respectively, of partnership DEF. Dana and Edward are related under §267(c). Dana sells property with \$8,000 market value and \$12,000 basis to DEF for \$8,000. Dana cannot recognize any of the \$4,000 loss.

Example 11. Use the same facts as **Example 10**, except DEF, as transferee, sells the property for \$15,000. DEF's realized gain of \$7,000 ($\$15,000 - \$8,000$) less Dana's disallowed deferred loss of \$4,000 ($\$8,000 - \$12,000$) equals a \$3,000 gain that DEF must recognize.

If the property being sold or exchanged is not a capital asset under IRC §1221 (that is, the property is a trade accounts receivable, inventory, stock in trade, depreciable property used in a trade or business, or real property used in a trade or business), and the partner directly or indirectly owns more than 80% of the capital interest or profits interest in one or both partnerships involved in the transaction, then gains are treated as ordinary income.⁸⁰

⁷⁶ Treas. Reg. §1.707-1(c). See example 3.

⁷⁷ Treas. Reg. §1.707-1(c). See example 4.

⁷⁸ IRC §707(b)(1).

⁷⁹ IRC §267(d).

⁸⁰ Treas. Reg. §1.707-1(b)(2).

Example 12. Partner Gary has an 85% interest in GH partnership and a 90% interest in the GJ partnership. Gary sells a delivery van that had been used in GJ and depreciated to an adjusted basis of \$8,000 to GH for \$10,000. GH plans to use the van in its business. Gary recognizes \$2,000 **ordinary** gain from GH.

QUALIFIED BUSINESS INCOME DOES NOT INCLUDE GUARANTEED PAYMENTS

TCJA⁸¹ added IRC §199A — at least for tax years after December 31, 2017, through December 31, 2025 — to provide pass-through entities such as partnerships with a benefit similar to the reduced corporate tax rate. IRC §199A(a) allows a taxpayer who is not a corporation to deduct the lesser of:

- The taxpayer's combined qualified business income (QBI), or
- 20% of the excess of the taxpayer's taxable income over net capital gain.

IRC §199A(c)(4) excludes guaranteed payments from the definition of QBI. Guaranteed payments reduce the amount of QBI, and guaranteed payments do not qualify as Form W-2, *Wage and Tax Statement*, payments. Thus, reliance on guaranteed payments reduces the potential QBI deduction.

Note. For more information on specific QBI rules, 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](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

See also the 2023 *University of Illinois Federal Tax Workbook*, Chapter 10: Small Business Issues.

ALLOCATIONS

The general rule of partnership taxation under subchapter K is that a partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement.⁸² Partners are usually able to allocate these items under the partnership agreement in any manner they choose unless allocations lack substantial economic effect.⁸³ The most basic form of allocation is simply to allocate all items among the partners in proportion to their partnership ownership interest.

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

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

⁸¹ *Tax Cuts and Jobs Act*, PL 115-97.

⁸² IRC §704(a).

⁸³ IRC §704(b)(2).

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SUBSTANTIAL ECONOMIC EFFECT REQUIREMENT⁸⁴

A special allocation is an allocation of a partnership item that is disproportionate to the partners' capital contributions or to their ratio for sharing other partnership items. For special allocations to be respected, the regulations require that they have **substantial economic effect**. This means the income tax consequences of an allocation must be assigned to the partner who receives the benefit or bears the burden of the economic consequences.⁸⁵ For example, a partner who is allocated a disproportionately large share of depreciation must also be assigned the same disproportionately large reduction in the economic value of the partner's partnership interest. Thus, tax allocations **must be matched** by economic allocations — or, as commonly stated, taxes must follow the money.

If an allocation is found not to have substantial economic effect, the offending allocation is required to be reallocated among the partners in proportion to their **interests in the partnership**.⁸⁶ This is based on the manner in which the partners have agreed to share the economic benefit (income) or burden (deduction), if any, corresponding to the item that is specially allocated. It is a facts-and-circumstances determination, with no set rules. In determining a partner's interest in the partnership, the regulations list the following factors as being among those that are considered.⁸⁷

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

The determination of whether an allocation has substantial economic effect involves a 2-part analysis that is made at the end of the partnership tax year to which the allocation relates.⁸⁸

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

ECONOMIC EFFECT⁸⁹

To ensure allocations have the necessary economic effect, the regulations require that, throughout the full term of the partnership, the partnership agreement contain the following provisions.⁹⁰

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

⁸⁴ Treas. Reg. §1.704-1(b)(2).

⁸⁵ Treas. Reg. §1.704-1(b)(2)(ii)(a).

⁸⁶ Treas. Reg. §1.704-1(b)(1)(i).

⁸⁷ Treas. Reg. §1.704-1(b)(3)(ii).

⁸⁸ Treas. Reg. §1.704-1(b)(2)(i).

⁸⁹ Treas. Reg. §1.704-1(b)(2).

⁹⁰ Treas. Reg. §1.704-1(b)(2)(ii)(b).

Example 13. Satisfaction of Economic Effect Test. Giselle and Marcus form an LLC with cash contributions of \$40,000 each. This is used to purchase depreciable property for \$80,000. The operating agreement provides that the members share income and losses equally except that all depreciation deductions are allocated to Giselle. The operating agreement further complies with the economic effect requirements, including a DRO.

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

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

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

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

In the preceding example, the value of the asset is deemed to decline to the extent of the tax depreciation.⁹¹ Furthermore, the capital accounting rules do not permit revaluation of the asset to determine its true market value on the presumed liquidation date.⁹² This is in keeping with the requirement that value equals basis, which ensures that tax allocations have a dollar-for-dollar impact on a partner's economic investment in the partnership.

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

Example 14. Failure of Liquidating Test. Use the same facts as **Example 13**, except that, upon liquidation, distributions are made equally between Giselle and Marcus without regard to capital accounts. Each member is therefore entitled to a distribution of \$30,000. This fails to satisfy the economic effect test because Marcus's cumulative economic investment in the LLC is \$40,000, yet he receives only \$30,000 in liquidation. Giselle, on the other hand, has a cumulative economic investment of only \$20,000, but she receives a \$30,000 distribution.

In effect, Marcus pays for half of the depreciation deduction without being allocated any of it.⁹³ This fails the economic effect test, and the depreciation deduction must be reallocated in accordance with the members' equal interests in the LLC.

⁹¹ Treas. Reg. §1.704-1(b)(2)(iv)(g)(1).

⁹² Treas. Reg. §1.704-1(b)(2)(iv)(f).

⁹³ Treas. Reg. §1.704-1(b)(2)(ii)(b)(2).

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Example 15. Failure of DRO. Mitch and Rita form an LLC with contributions of \$75,000 and \$25,000, respectively. The operating agreement divides all items of income and loss equally between the two members and otherwise satisfies the requirements of the regulations except that there is no DRO and the alternate test is not satisfied. Therefore, the agreement does not satisfy the economic effect test, and the allocations will not be respected.

The LLC has a total of \$60,000 in losses from its first three years of operation. Therefore, each partner, has \$30,000 of losses allocated to their capital accounts. If the allocations in the operating agreement were honored and the partnership liquidated at the end of Year 3, the capital accounts would be as follows.

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

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

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

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

If there is no express obligation for a DRO in the operating agreement, the partner can contribute a **promissory note** to the LLC. A promissory note constitutes a DRO to the extent of its outstanding principal balance as long as the partner is the maker of the note and meets the following requirements.⁹⁴

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

Example 16. Curative DRO. Use the same facts as **Example 15**, except Rita contributed a promissory note to the LLC with a face amount of \$5,000. If the note satisfies the requirements of the regulations, Rita is treated as having a \$5,000 limited DRO, and the allocation of the additional \$5,000 loss to Mitch will be respected.

A partner is permitted to reduce or eliminate an existing DRO as long as the reduction or elimination operates only prospectively and does not affect a DRO the partner may have for an existing deficit capital account.⁹⁵

⁹⁴ Treas. Reg. §1.704-1(b)(2)(ii)(c).

⁹⁵ Treas. Reg. §1.704-1(b)(2)(ii)(f).

A member's **guarantee of an LLC's debt** owed to a third party is **not** the same thing as a DRO. A DRO is essentially a debt owed to another partner in the partnership, not to third parties. The existence of guarantees by LLC members relates to whether the LLC's debt is classified as recourse or nonrecourse for purposes of allocating basis among partners.⁹⁶

Example 17. Guarantee of Third-Party Debt. Viola and Tom contribute \$7,500 and \$2,500, respectively, to an LLC taxed as a partnership. The LLC borrows \$90,000, with each partner signing a full guarantee of the entire \$90,000. Other income and expenses are equal and the depreciation deduction is in excess of those items. All tax items are divided between the partners based on their ownership percentages except depreciation, which is allocated equally between them. The operating agreement satisfies the requirements for the economic effect test except that there is no DRO (nor compliance with the alternate test).

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

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

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

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

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

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

⁹⁶ Treas. Reg. §1.752-1(a)(1).

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Example 18. Curative Allocation. Because the depreciation allocations in **Example 17** do not satisfy the economic effect test, they must be reallocated in accordance with the partners' interests in the LLC. This requires a curative allocation of \$5,000 of depreciation in Years 1 and 2 to be reallocated to Viola (again ignoring the failure to satisfy the economic effect test in Year 1). This results in negative capital account balances for both partners and matching income tax losses in proportion to their interests in the LLC.

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

Alternate Economic Effect Test.⁹⁷ The alternate economic effect test is classically used by limited partnerships and generally appears to be used for LLCs. The first two requirements for economic effect (maintenance of capital accounts and positive account liquidating distributions) must be satisfied.⁹⁸ Instead of a DRO, however, the partnership agreement can provide for a **qualified income offset (QIO)**.⁹⁹ This is a provision in the partnership agreement that satisfies the following requirements.

- No allocation can be made to a partner with a QIO that causes or increases a deficit balance in that partner's capital account as of the end of the partnership tax year to which the allocation relates.¹⁰⁰
- The partnership agreement must provide that a partner who unexpectedly receives allocations or distributions resulting in a deficit capital account is allocated pro rata items of partnership income and gain in an amount and manner sufficient to eliminate the deficit balance as quickly as possible.¹⁰¹

⁹⁷ Treas. Reg. §1.704-1(b)(2)(ii)(d).

⁹⁸ Treas. Regs. §§1.704-1(b)(2)(ii)(d)(1) and (2).

⁹⁹ Treas. Reg. §1.704-1(b)(2)(ii)(d)(3).

¹⁰⁰ Ibid.

¹⁰¹ Treas. Reg. §1.704-1(b)(2)(ii)(d).

In determining the capital account of a partner with a QIO at the end of a tax year for allocation purposes, the regulations require the capital account to be reduced first to reflect the following adjustments that are reasonably expected at the end of the year to be made in subsequent years.¹⁰²

- Oil and gas depletion
- Losses and deductions allocated to the partner under the family partnership rules,¹⁰³ the rules governing retroactive allocations,¹⁰⁴ and the rules governing disproportionate distributions of unrealized receivables and substantially appreciated inventory¹⁰⁵
- Distributions the partner anticipates receiving that exceed reasonably expected increases in the partner's capital account in the same year as the subsequent distribution

Observation. The income allocations are for both tax and capital account purposes, but distributions based on that income are still in accordance with the partnership agreement.¹⁰⁶ This is because a partner with a deficit capital account has essentially borrowed from the other partners and is therefore required to pay them back.

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

Caution. It is important to understand that “unexpected” does not include such events as an unforeseen loss from the normal business operations of the partnership. However, a partner subject to the alternate economic effect test and who has a zero or deficit capital account for any year is prevented from being allocated any of the “usual” partnership deductions and losses attributable to its normal operations, even if they are unexpected in an economic or business sense.¹⁰⁷

The alternate economic effect test is **applied on an annual basis**.¹⁰⁸ The test may therefore be satisfied in some years but not in others or may be only partially satisfied in a year. To the extent the test is not satisfied in any year, special allocations are prohibited unless they satisfy the economic effect requirement in some other manner, such as economic effect equivalence (discussed later).¹⁰⁹

¹⁰². Ibid.

¹⁰³. Treas. Reg. §1.704-1(b)(2)(ii)(d)(5); IRC §704(e).

¹⁰⁴. Treas. Reg. §1.704-1(b)(2)(ii)(d)(5); IRC §706(d)(1).

¹⁰⁵. Treas. Reg. §1.704-1(b)(2)(ii)(d)(5); IRC §751.

¹⁰⁶. Treas. Regs. §§1.704-1(b)(2)(ii)(d)(3)–(6).

¹⁰⁷. Ibid.

¹⁰⁸. Ibid.

¹⁰⁹. Ibid.

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The following examples illustrate the alternate economic effect test.

Example 19. Alternate Economic Effect Allocation. Waldo and Amy form an LLC organized as a partnership with cash contributions of \$40,000 each. The LLC uses these funds to buy depreciable personal property for \$80,000. All tax items are to be divided equally between Waldo and Amy except depreciation, which is allocated entirely to Waldo. Other income and expenses are equal and the depreciation deduction is in excess of those items. Assume the operating agreement satisfies the alternate economic effect test.

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

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

Example 20. Partial Alternate Economic Effect Allocation. Use the same facts as **Example 19**. The LLC has a \$25,000 depreciation deduction in Year 2 allocated entirely to Waldo. Because this causes Waldo's capital account to have a deficit of \$5,000 (\$20,000 capital account end of Year 1 – \$25,000 depreciation), the allocation is valid only to the extent of \$20,000. The remaining \$5,000 of depreciation must be reallocated in accordance with the partners' interests in the partnership.

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

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

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Example 21. Invalid Allocation under Alternate Economic Effect. Use the same facts as **Example 20**, except that the depreciation deduction for Year 2 is \$20,000 instead of \$25,000. In addition, the property is sold for \$35,000 at the beginning of Year 3, which results in a \$5,000 tax loss (\$35,000 sales price – (\$80,000 cost of property – \$40,000 total depreciation for Years 1 and 2)), and the partnership is liquidated. Allocations in accordance with the partnership agreement result in the following capital accounts after the sale.

	Waldo		Amy	
	Tax Basis	Book Basis	Tax Basis	Book Basis
Capital account beginning of Year 2	\$20,000	\$20,000	\$40,000	\$40,000
Depreciation Year 2	(20,000)	(20,000)	0	0
Capital account end of Year 2	\$ 0	\$ 0	\$40,000	\$40,000
Loss on sale in Year 3	(2,500)	(2,500)	(2,500)	(2,500)
Interim capital account before liquidation	(\$ 2,500)	(\$ 2,500)	\$37,500	\$37,500

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

	Waldo		Amy	
	Tax Basis	Book Basis	Tax Basis	Book Basis
Capital account beginning of Year 2	\$20,000	\$20,000	\$40,000	\$40,000
Depreciation Year 2	(20,000)	(20,000)	0	0
Capital account end of Year 2	\$ 0	\$ 0	\$40,000	\$40,000
Loss on sale in Year 3	0	0	(5,000)	(5,000)
Interim capital account before liquidation	\$ 0	\$ 0	\$35,000	\$35,000

Example 22. Qualified Income Offset. Use the same facts as **Example 21**, except that the property is not sold at the beginning of Year 3. At the end of Year 2, Waldo's capital account is zero and Amy's is \$40,000. In Year 3, the partnership borrows \$20,000 (which is unforeseen at the end of Year 2) and distributes \$10,000 each to Waldo and Amy. In addition, in Year 3, the partnership has income of \$50,000, expenses (exclusive of depreciation) of \$50,000, and depreciation of \$20,000.

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

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

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Example 23. Allocation in Accordance with Partners' Interests in Partnership. Use the same facts as **Example 22**, except the partnership had \$40,000 of gross income instead of \$50,000 and \$10,000 of the \$40,000 is specially allocated to Waldo. Losses and deductions of the partnership for the year total \$40,000. The first \$30,000 is allocated entirely to Amy, reducing her capital account to zero. Because both partners now have zero capital accounts, the remaining \$10,000 of the loss must be allocated in accordance with the partners' interests in the partnership. Based on their equal capital contributions and share of items other than depreciation, the \$10,000 excess is allocated \$5,000 to each partner. This leaves each partner with a \$5,000 deficit capital account at the end of Year 3.

Economic Effect Equivalence.¹¹⁰ **Economic effect equivalence** is sometimes referred to as “dumb but lucky.” It applies to allocations that fail the economic effect or alternate economic effect tests. As long as the partners can demonstrate that the economic effect of the allocation is equivalent to the results that would have occurred under either of the two tests, however, the allocation is accepted. This requires the partners to show that a liquidation of the partnership in the current or any future year would have the same economic effect as if the partnership agreement contained a requirement for capital accounts, liquidating distributions with respect to positive capital accounts, and a DRO.

Substantial Effect

To satisfy the substantial economic effect requirement, not only must special allocations have economic effect, but the **economic effect must be substantial**.¹¹¹ This is a **separate requirement**. An allocation that has economic effect may not have a substantial economic effect. An economic effect is substantial only if it has a **substantial impact on the dollar amounts** the partners will receive independently of tax consequences.¹¹²

For purposes of determining substantial effect, **value generally equals basis**. This means the FMV of assets is presumed to be equal to their adjusted bases. If book value differs from adjusted basis, however, book value is used instead.¹¹³ This rule is intended to prevent partnerships from attempting to justify special allocations based on anticipated increases in the value of partnership assets.¹¹⁴

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

- 1. After-tax economic consequences.** The allocation is not substantial if, at the time the allocation becomes part of the partnership agreement:
 - The after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation was not contained in the partnership agreement; and
 - There is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished.¹¹⁵
- 2. Shifting allocations.** These are special allocations that occur within a tax year that have the same effect on partners' capital accounts as if the special allocations had not been made, but that result in a lower overall income tax liability for the partners than would have occurred without the allocations.¹¹⁶
- 3. Transitory allocations.** These are special allocations that occur over more than one tax year. At the end of this period, the partners' capital accounts are substantially the same as they would have been without the special allocations, but the partners' overall tax liability is less than it would have been without the allocations.¹¹⁷

¹¹⁰ Treas. Reg. §1.704-1(b)(2)(ii)(i).

¹¹¹ Treas. Reg. §1.704-1(b)(2)(i).

¹¹² Treas. Reg. §1.704-1(b)(2)(iii)(a).

¹¹³ Ibid.

¹¹⁴ Ibid.

¹¹⁵ Ibid.

¹¹⁶ Treas. Reg. §1.704-1(b)(2)(iii)(b).

¹¹⁷ Treas. Reg. §1.704-1(b)(2)(iii)(c).

In applying the substantial effect rules, the “nonpartner” individual tax attributes of a partner that are unrelated to their status as a partner must be taken into account.¹¹⁸ This includes such factors as whether a partner is subject to tax or is tax-exempt, is insolvent or in bankruptcy, or has a net operating loss carryover from an activity other than the partnership.

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

Shifting Allocations.¹¹⁹ Shifting allocations are special allocations of tax items within a single tax year that have no different effect on the partners’ year-end capital accounts. This means that the partners’ capital accounts would have been the same without the special allocations. If this is the case, there is a strong presumption that the special allocations lack substantial economic effect. However, the partners can rebut the presumption by showing that facts and circumstances indicate that a strong likelihood of a shifting allocation did not exist at the time the provision for the allocation became part of the partnership agreement.

To apply the shifting allocation test, the partners’ year-end capital accounts with the special allocation must be compared to what their capital accounts would have been without the allocation. If there is no substantial difference, the partners’ tax liabilities with and without the allocation must then be compared, taking into account each partner’s nonpartnership tax attributes.¹²⁰

Example 24. Shifting Allocation. James and Sharon form a partnership and contribute equal amounts to its capital. The partnership agreement satisfies the requirements of the general economic effect test. The partnership agreement also provides that James and Sharon share equally in all items of partnership income and loss.

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

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

Transitory Allocations. Transitory allocations occur over more than one tax year. Otherwise, they are analyzed in essentially the same manner as shifting allocations. There are two exceptions to the transitory allocation rules.¹²¹

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

¹¹⁸ Treas. Reg. §1.704-1(b)(2)(iii)(a).

¹¹⁹ Treas. Reg. §1.704-1(b)(2)(iii)(b).

¹²⁰ Ibid.

¹²¹ Treas. Regs. §§1.704-1(b)(2)(iii)(c) and 1.704-1(b)(5), Example 3.

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Example 25. Transitory Allocation. Use the same facts as **Example 24**, except the partnership owns depreciable real property generating \$50,000 in annual depreciation deductions. Because James expects to be in a substantially higher marginal tax bracket than Sharon during the partnership's first tax year, they agree to allocate the first year of depreciation deductions to James and the second year of depreciation deductions to Sharon. All other items are shared equally, and this allocation has economic effect.

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

EFFECT OF IRC §§734(b) AND 743(b) ADJUSTMENTS

Observation. Adjustments under §§734(b) and 743(b) are only made if the partnership has made a §754 election. This election is irrevocable without the consent of the IRS.¹²² Practitioners making a §754 elections must consult the appropriate regulations.¹²³

IRC §754 ELECTION

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

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

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

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

- IRC §743(b) and its regulations¹²⁴ for transfers of partnership interests
- IRC §734(b) and its regulations¹²⁵ for distributions in a manner that restores equality between inside and outside basis

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

- IRC §755 and its regulations¹²⁶ provide the actual manner in which allocations are made.
- IRC §754 and its regulations¹²⁷ provide the manner in which the election is made.

¹²² Treas. Reg. §1.754-1(c)(1).

¹²³ Treas. Reg. §§1.734-1 and 1.734-2 (adjustments to partnership's inside basis based on distributions to partners); Treas. Reg. §1.743-1 (adjustments to partner's outside basis and share of partnership's inside basis); Treas. Reg. §1.755-1 (allocation of bases among partnership assets for adjustments under §§734 and 743).

¹²⁴ Treas. Reg. §1.743-1.

¹²⁵ Treas. Regs. §§1.734-1 and 1.734-2.

¹²⁶ Treas. Reg. §1.755-1.

¹²⁷ Treas. Reg. §1.754-1.

Making the Election

The §754 election must be made by the partnership before the due date of the partnership income tax return (including extensions) for the year in which the distribution or transfer occurs.¹²⁸ No particular form is required for the election, but the election must include the name and address of the electing partnership, a declaration that the partnership elects, under §754, to apply the provisions of §§734(b) and 743(b), and the signature of any partner.¹²⁹ The election must be made in a written statement filed with the partnership return for a tax year not later than the year in which the distribution occurs.

Example 26. During 2012, Alicia, Barry, Charles, and Deidre formed Happy Valley Farm Partnership. They each contributed \$500,000 to the partnership. With the \$2 million of contributed cash, the partnership bought land for \$1.2 million and other nondepreciable assets for \$800,000. As a result, after formation and purchase of assets, the partnership's balance sheet is as follows.

	Book/Tax Basis
Land	\$1,200,000
Other nondepreciable assets	800,000
Total assets	\$2,000,000
Capital account: Alicia	\$ 500,000
Capital account: Barry	500,000
Capital account: Charles	500,000
Capital account: Deidre	500,000
Total equity	\$2,000,000

Each partner has a capital account equal to the amount of cash that particular partner contributed to the partnership. The total of the partners' capital accounts equals the total basis the partnership has in its assets. Thus, the partnership has an inside basis in its partnership assets of \$2 million, and each partner's share of that inside basis is \$500,000.

In early 2022, the value of the land held by the partnership was appraised at \$1.8 million and the other assets were valued at \$800,000. Assuming there were no other changes, the partnership's balance sheet in 2022 is as follows.

	Book/Tax Basis	FMV
Land	\$1,200,000	\$1,800,000
Other nondepreciable assets	800,000	800,000
Total assets	\$2,000,000	\$2,600,000
Capital account: Alicia	\$ 500,000	\$ 650,000
Capital account: Barry	500,000	650,000
Capital account: Charles	500,000	650,000
Capital account: Deidre	500,000	650,000
Total equity	\$2,000,000	\$2,600,000

¹²⁸. An automatic 12-month extension is possible if certain procedural requirements are followed. Treas. Reg. §301.9100-2.

¹²⁹. Treas. Reg. §1.754-1(b). The IRS proposed regulations in 2017 that would eliminate the signature requirement for a §754 election. This amendment is final when published as a final regulation, but taxpayers may rely upon it for tax years preceding the proposed effective date. The IRS will apparently no longer take the position that the lack of a signature on the election form invalidates the election. See, e.g., *DTDV, LLC v. Comm'r*, TC Memo 2018-32 (Mar. 20, 2018).

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In mid-2022, Alicia sells her interest to Edwin for \$650,000. Alicia recognizes gain of \$150,000 on the sale¹³⁰ (\$650,000 – \$500,000 basis). Edwin’s basis in the partnership interest (outside basis) is the purchase price of \$650,000.¹³¹ However, Edwin’s share of the inside basis the partnership holds in its assets is \$500,000. With respect to inside basis, Edwin merely “steps into the shoes” of Alicia’s previous capital account of \$500,000. Thus, after the transaction, Edwin’s capital account differs from his tax basis, as shown in the following table.

	Capital Account Inside Basis	Tax Basis Outside Basis
Barry	\$ 500,000	\$ 500,000
Charles	500,000	500,000
Deidre	500,000	500,000
Edwin	500,000	650,000
Total equity	\$2,000,000	\$2,150,000

The partnership made a §754 election for the year in which Edwin purchased Alicia’s interest. Accordingly, the partnership increased the basis of its land by the amount that Edwin’s outside basis in the acquired interest (\$650,000) exceeded his share of the inside basis (\$500,000). Thus, the partnership increased the basis of its land by \$150,000, which is the same amount as the gain that Alicia recognized on the sale.

The §754 election was identified on Happy Valley Farm Partnership’s Form 1065, Schedule B, *Other Information*, line 10a. The optional basis adjustment was marked on Form 1065, Schedule B, line 10b, and a statement showing the computation and allocation of the basis adjustment was attached to the return. In addition, the §754 election statement was attached.

Foreign Trust		See instructions	
10a	Is the partnership making, or had it previously made (and not revoked), a section 754 election? See instructions for details regarding a section 754 election.	☒	
b	Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If “Yes,” attach a statement showing the computation and allocation of the basis adjustment. See instructions	☒	
c	Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If “Yes,” attach a statement showing the computation and allocation of the basis adjustment. See instructions		

Form **1065** (2022)

Sample IRC §754 election statement

Election to Adjust the Basis of Partnership Property of Happy Valley Farm Partnership, Farm Avenue, Farm Town

Pursuant to Treas. Reg. §1.754-1(b)(1), the partnership hereby elects to adjust the basis of the partnership property for the tax year ended 12/31/22. Under the provisions of the Internal Revenue Code, this partnership will elect to apply IRC §§734(b) and 743(b).

Statement 1

Form 1065, Schedule B, Line 10b Optional Basis Adjustment Supporting Detail

Land basis adjustment: \$150,000

Allocated to partner Edwin

¹³⁰. IRC §741.

¹³¹. IRC §1012.

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Form 1065 instructions take into account partnership basis adjustments under §734(b) on the line for “other increases and decreases.” However, adjustments to partnership basis under §743(b) that pertain only to a particular partner are disregarded. Therefore, if the beginning tax basis capital account included any positive or negative §743(b) adjustments for a partner, they should have been removed by reducing positive adjustments and increasing negative adjustments by the §743(b) portion. The following sections examine these adjustments and the distinction between the two.

IRC §734 ADJUSTMENTS

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

Example 27. Ann, Bernard, and Cora are equal partners in a partnership. The partnership's balance sheet follows.

	Tax Basis	FMV
Assets		
Cash	\$2,000	\$2,000
Capital asset	1,000	4,000
Total	\$3,000	\$6,000
Capital		
Ann	\$1,000	\$2,000
Bernard	1,000	2,000
Cora	1,000	2,000
Total	\$3,000	\$6,000

Ann receives a liquidating distribution of \$2,000 in cash and therefore recognizes \$1,000 of gain (\$2,000 cash – \$1,000 basis). With no §754 election in effect, the partnership's balance sheet following the distribution is as follows.

	Tax Basis	FMV
Assets		
Capital asset	\$1,000	\$4,000
Total	\$1,000	\$4,000
Capital		
Bernard	\$1,000	\$2,000
Cora	1,000	2,000
Total	\$2,000	\$4,000

If the partnership sells the asset for its \$4,000 value, the partnership has a \$3,000 gain, half of which is reported by each of the remaining partners. Thus, \$4,000 of gain has been reported between the distributee partner (Ann) and the remaining partners, when there was only \$3,000 of appreciation in the partnership assets. However, partners Bernard and Cora receive increases in their tax bases of \$1,500 each with respect to the gain they have reported. Thus, they have \$2,500 of tax basis each following the sale of the asset.

Each of them is entitled to a tax-free liquidating distribution of \$2,000, resulting in a \$500 capital loss to each. Thus, the net taxable amount among all concerned is only \$3,000, but the lack of a §754 election results in a distortion. With the election in effect, the partnership's basis in the asset would have been increased by the \$1,000 of gain recognized by Ann, resulting in only \$2,000 of gain on a sale of the asset. Thus, the distortion would have been avoided.

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

IRC §743 ADJUSTMENTS

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

Example 28. Derek and Erin own a 40% and 60% interest in partnership DE, respectively, with an FMV of \$100 and an adjusted basis of \$50. Derek sells his interest to Farrell for \$100. The partnership has a depreciable asset with an FMV of \$200 and an adjusted basis of \$100, of which Derek's share of inside basis is \$40.

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

DE partnership made a §754 election. Farrell can increase the inside basis he has in the asset by \$60, the excess of his outside basis (\$100) over his share of the partnership's inside basis (\$40).

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

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

DEBT-FINANCED ACQUISITIONS AND DISTRIBUTIONS

The Tax Reform Act of 1986 made significant changes to interest expense deductions. In general, it created five different categories of interest expenses, each with different rules of deductibility.¹³² These are the most common categories and are applicable to both partnerships (as well as S corporations) and individuals.

1. **Personal interest**, which is not deductible
2. **Trade or business interest**, which is generally fully deductible (ignoring such things as capitalization rules or limits on losses)
3. **Investment interest**, deductible to the extent of net investment income
4. **Passive activity interest**, deductible to the extent of passive activity income
5. **Qualified residence interest**, deductible in accordance with the Code and regulations¹³³

The issue is how to determine which type of interest a taxpayer has paid. To address this, the IRS issued temporary regulations that are still in effect. These are referred to in the materials as **interest tracing**.

¹³². IRC §163(h)(2).

¹³³. Temp. Treas. Reg. §1.163-10T (not updated to reflect certain post-1986 statutory changes).

INTEREST TRACING RULES

The interest tracing rules are actually **debt tracing** rules, and are found in the temporary regulations at Temp. Treas. Reg. §1.163-8T. In general, the interest tracing rules work in the following manner.

If an individual borrows money, the type of interest that accrues on the borrowed money is determined by the **use** to which the taxpayer puts the debt.¹³⁴ The use of the debt is determined by tracing expenditures of the debt by the taxpayer to see what the taxpayer actually uses it for.¹³⁵ Thus, if a taxpayer receives \$100,000 of loan proceeds in cash and uses the cash to buy a building, the \$100,000 debt is traced directly to that building. Similarly, if \$100,000 of debt proceeds are deposited to a taxpayer's checking account and the taxpayer writes a check using the \$100,000 of debt to buy a building (or the check is issued at closing by a closing agent), that debt will be traced to the building.

When an expenditure of debt by a taxpayer has been traced to an asset or use, the debt is attached to the asset or use (hereafter referred to as asset). The taxpayer must then determine how the taxpayer uses the asset to which the debt has attached, taking into account the passive activity rules. The use of the asset characterizes the use of the debt proceeds that are attached to it and the use of the debt proceeds characterizes the type of interest that accrues on the debt.¹³⁶

Example 29. A taxpayer borrows \$100,000 and uses it to purchase a building. The debt is attached to the building. The building is used the entire year in a trade or business in which the taxpayer materially participates. The debt is therefore trade or business debt and the interest that accrues during that period of time is trade or business interest.

If the use of an asset changes, the regulations require the attached debt to be **reallocated** to the new use.¹³⁷ Any interest that accrues after a reallocation of debt proceeds will be characterized by the new use of the debt brought about by the changing use of the asset to which the debt attaches.

Example 30. Use the same facts as **Example 29** except that the taxpayer stops using the building in the business and begins to rent it. Because rental is a passive activity, the use of the asset has changed and the attached debt must therefore be reallocated to the new use. Thus, the debt becomes passive activity debt and the interest that accrues from the point of reallocation forward will be treated as passive activity interest and subject to those limitations.

If an asset having debt attached to it is disposed, any proceeds are traced back to the taxpayer. If the proceeds are used to repay the debt, interest tracing stops. If, however, the debt is not repaid, the proceeds will continue to be treated as debt and will be traced (reallocated) to new assets as expenditures of the proceeds are made.

Except in the case of a qualified residence indebtedness, the interest tracing rules apply **without regard** to what property secures a debt.¹³⁸ Thus, if a taxpayer has a certificate of deposit (CD) in a bank that the bank uses as collateral for a loan used for business purposes, the debt is still treated as business debt and the interest as business interest because it is traced to the business and not to the CD.

The regulations provide that any time a **deposit of debt** proceed is held in any kind of banking account, regardless of whether the account pays interest, the debt is treated for that time as used for investment purposes. Thus, a taxpayer who deposits borrowed funds into a checking account and who does not immediately write a check carrying the debt out of that account will technically have investment interest for some period of time.¹³⁹

¹³⁴. Temp. Treas. Reg. §1.163-8T(c)(1).

¹³⁵. Temp. Treas. Reg. §1.163-8T(a)(3).

¹³⁶. Temp. Treas. Reg. §1.163-8T(c)(2)(ii)(A).

¹³⁷. Temp. Treas. Reg. §1.163-8T(j)(1).

¹³⁸. Temp. Treas. Reg. §1.163-8T(c)(1).

¹³⁹. Temp. Treas. Reg. §1.163-8T(c)(4).

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If loan proceeds are paid directly from the lender to a third party, debt is automatically allocated to that disbursement.¹⁴⁰ If a taxpayer receives debt in cash or is deposited to the taxpayer's account, the general rule is that debt proceeds are treated as paid out by the taxpayer on a first-in, first-out basis. This means that if the proceeds from more than one loan have been deposited in a checking account, the money from the loans is treated as being paid out chronologically in the same order the loans were received. Unborrowed money is treated as being paid out of the account after all loan money has been paid out.

There is a 30-day exception to the general rule, however, which should apply to most taxpayers.¹⁴¹ Under this rule, any payments made within 30 days before or after debt proceeds have been received can be designated by the taxpayer as being expenditures of debt proceeds without regard to any ordering rules.

PASSTHROUGH ENTITIES

Prior to the Tax Reform Act of 1986, a taxpayer incurring debt to buy an interest in a corporation or partnership was treated as purchasing an investment interest. This applied in the case of corporation stock without regard to whether the corporation was a C corporation or an S corporation. Any interest paid would therefore have been investment interest and deductible only to the extent of net investment income.

The IRS became concerned that individuals would try to use passthrough entities to circumvent the prohibition against deducting personal interest. It therefore issued a series of notices which, until regulations are issued in this area, govern how taxpayers who use debt to acquire an interest in a passthrough entity must determine their interest deductions and how the entities are to determine interest on debt-financed distributions.

The first of these was IRS Notice 88-20,¹⁴² which provided the original allocation rules. The second was IRS Notice 88-37,¹⁴³ which set out how taxpayers report interest determined under IRS Notice 88-20. Both notices have been modified. IRS Notice 88-20 is largely superseded by IRS Notice 89-35,¹⁴⁴ which restates and elaborates the rules of IRS Notice 88-20 and, to some extent, those of IRS Notice 88-37. Anyone who has clients with interests in partnerships, LLCs classified as partnerships, or S corporations should be familiar with these notices.

DEBT-FINANCED ACQUISITIONS¹⁴⁵

If a taxpayer incurs debt to purchase an interest in a partnership, it is treated not as the purchase of an interest in the partnership itself, but as if the debt had been used instead to purchase an interest directly in the assets of the partnership. The debt is allocated among the assets of the partnership in accordance with the rules in IRS Notice 89-35. Once the debt has been allocated among assets, a taxpayer must determine how each asset is used by the partnership to classify properly the debt attached to those assets. The use of assets — trade or business, passive activity, investment, or personal — is determined on the basis of the partnership's use of the assets. This determines the nature of the interest accruing on the allocated debt and thereby determines how partners report the interest on their returns.

¹⁴⁰. Temp. Treas. Reg. §1.163-8T(c)(3).

¹⁴¹. Prop. Treas. Reg. §1.163-15(a); IRS Notice 89-35, 1989-1 CB 675.

¹⁴². IRS Notice 88-20, 1988-1 CB 487.

¹⁴³. IRS Notice 88-37, 1988-1 CB 522.

¹⁴⁴. IRS Notice 89-35, 1989-1 CB 675.

¹⁴⁵. Ibid.

Types of Debt-Financed Acquisitions

Partners determine how debt is allocated among assets of the partnership based on whether the purchase is treated as a **debt-financed acquisition that is not a contribution to capital** or as a **debt-financed acquisition that is a contribution to capital**. The difference between these two is simply where the money goes. If the partnership winds up with the borrowed money, the partners treat the debt as a debt-financed acquisition that **is** a contribution to capital. If a partner or anyone other than the partnership gets the money, it is a debt-financed acquisition that **is not** a contribution to capital.¹⁴⁶



Practitioner Planning Tip

To determine whether there is a debt-financed acquisition of an interest in a passthrough entity, practitioners should look to see whether (1) debt was incurred at either the partner or the partnership level and (2) as a result of that, someone's equity ownership interest in the partnership was directly or indirectly increased.

Example 31. Alice borrows \$100,000 from a bank to buy an interest in an LLC. If Alice contributes the money to the LLC in exchange for an interest in the LLC, this is a debt-financed acquisition that is a contribution to capital. If Alice buys the LLC interest from another member, it is a debt-financed acquisition that is not a contribution to capital. Thus, in the first scenario the LLC winds up with the money, while in the second someone else does. In either case, however, Alice's equity interest in the partnership is increased.

Example 32. An LLC borrows money from a bank to redeem a member's interest. Because the member winds up with the money and the equity interests of the remaining members is increased by the departure of the redeemed member, this is a debt-financed acquisition by the remaining members that is not a contribution to capital. This is true even though it was the LLC that borrowed the money and pays the interest, and even if there is no loan guarantee by the members. Each member's share of the LLC's interest will therefore have to be specially allocated to the members for them to apply the principles discussed in these materials for determining their interest expense deduction on their proportionate share.

Note. The following examples from private letter rulings applying IRS Notice 89-35 illustrate various transactions and how they are classified under the Notice. With one exception, the rulings deal with S corporations. They are included here because the principles illustrated by these rulings are generally applicable to partners and partnerships, too.

¹⁴⁶ IRS Notice 88-20, 1988-1 CB 487.

Not a Contribution to Capital

In the following letter rulings, transactions were treated as debt-financed interests that were not a contribution to capital.

- **Stock purchase from shareholder.** Two employees purchased 100% of the shares of an S corporation from the owner. The buyers gave the seller a promissory note for the purchase price. This is a debt-financed acquisition that is not a contribution to capital because the selling shareholder received the proceeds and, as a result of the debt-financed purchase, the buyers increased their equity interests in the S corporation. If the buyers instead borrowed the money from a bank and paid the seller cash, the result would have been the same.¹⁴⁷ This is equally applicable to borrowing money to buy a partner's interest in a partnership.
- **Trust distribution to beneficiaries.** Two electing small business trusts (ESBTs) held all the stock of an S corporation. The ESBTs had current income beneficiaries who were entitled to all income for life, following which distribution of the shares would be made to the remainder beneficiaries. To resolve family feuding, the S corporation would make loans to the two ESBTs on arm's-length terms, using as part of the loan proceeds money the corporation would borrow from an unrelated third party. The ESBTs would use the loans to buy out the interests of the life income beneficiaries and some of the remainder beneficiaries to whom the shares would ultimately have been distributed on termination of the trust. The trusts would then be terminated and the shares distributed to the remainder beneficiaries whose interests had not been bought out.

The beneficiaries would take distribution of their shares subject to a security interest the corporation had in those shares for repayment of the loan, and they would assume and agree to pay back to the corporation the ESBT's loan. The IRS ruled that the remainder beneficiaries should treat the debt as if it were incurred for purposes of their purchasing the stock, making this a debt-financed acquisition, not a contribution to capital.¹⁴⁸ This is because other shareholders wound up with the money, not the corporation and as a result of the transaction, the equity interests of the remaining shareholders increased.

- **Corporate split-off.** To resolve irreconcilable differences between two 50-50 shareholders who owned an S corporation, the shareholders undertook a corporate split-off. To do so, the existing corporation formed a subsidiary to which it transferred assets in exchange for all the subsidiary's stock. To help equalize values, the parent corporation also borrowed money and distributed the borrowed money to the subsidiary. The shares in the parent corporation owned by the departing shareholder were then redeemed by the parent in exchange for all its shares in the newly formed subsidiary. The result was two separate corporations, each owned individually by one of the shareholders. The IRS treated the debt the parent incurred for equalization purposes as a debt-financed acquisition of an interest in an S corporation, not as a contribution to capital, but did not explain their reasoning.¹⁴⁹

The proper explanation, however, is that the subsidiary corporation wound up with the money borrowed by the parent. To be treated as a contribution to capital, IRS Notice 89-35 requires that the corporation that borrows the money also be the corporation which winds up with the money. In addition, the result of the transaction was to increase the ownership interest of the remaining shareholder in the parent corporation from 50% to 100%.

- **Redemption of shares.** An S corporation redeemed all the shares of some of the shareholders for cash and the corporation's promissory note. Because the effect of the redemption was to increase the ownership interests of the remaining shareholders and it was the redeemed shareholders who were getting the cash, the redemption was treated as debt-financed acquisition that was not a contribution to capital.¹⁵⁰

¹⁴⁷. Ltr. Rul. 9037027 (Jun. 18, 1990).

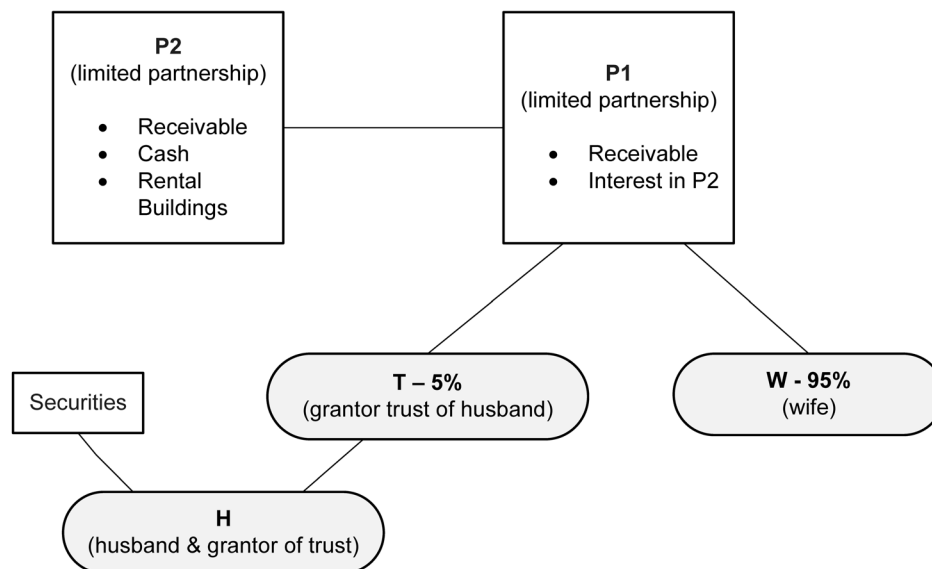
¹⁴⁸. Ltr. Rul. 9804026 (Oct. 23, 1997).

¹⁴⁹. Ltr. Rul. 9441025 (Jul. 11, 1994).

¹⁵⁰. Ltr. Rul. 9116008 (Jan. 10, 1991).

- **Partnership.** Nearly all letter rulings concerning IRS Notice 89-35 involve S corporations. In one letter ruling, however, the IRS addressed the issue of the deductibility of interest payments by the transferor spouse where there was an installment purchase of the transferee spouse's interest in a partnership that was community property.¹⁵¹ The purchase itself was not a taxable transaction because it was subject to the gift treatment rule of IRC §1041. The transferor spouse therefore received a carryover basis from the transferee spouse, the latter of whom recognized neither gain nor loss. The ruling set out the facts as follows.
 - ♦ *P1* is a California limited partnership formed in 1982. The husband, *H*, owned a 5% general partnership interest in *P1*'s profits, losses, and capital. In 1988, *H* transferred this interest in *P1* to trust *T*. *H* is the settlor, trustee, and current beneficiary of *T*. The agreement governing *T* provides that the settlor has the power to alter, amend, or revoke *T* in whole or in part by one or more written instruments, other than will, executed and delivered to the trustee from time to time during settlor's lifetime. *H*'s spouse (*W*) owns a 95% limited partnership interest in *P1*'s profits, losses, and capital.
 - ♦ *P1* owns a limited partnership interest in *P2*, another California limited partnership, and an interest in a receivable. *P2* owns an interest in a receivable, cash, and certain rental buildings and their improvements.
 - ♦ During their divorce, the couple negotiated a written settlement agreement providing that *H* purchase *W*'s interest in *P1*.
 - ♦ In 1987, *H* previously borrowed an amount and invested all the loan proceeds in certain securities. *H* will dispose of some of the securities and use all the proceeds from the disposition to pay *W* the purchase price for *W*'s interest in *P1*. *H* will then transfer this interest in *P1* to *T*.

The facts are visually represented by the following diagram.



In the ruling, the IRS concluded that the original debt proceeds, having been used to purchase portfolio property, would result in *H* having investment interest expenses up until the date of the disposition of the securities. When part of the securities were disposed, that portion of the debt proceeds attached to those securities was deemed reacquired by *H* and were thereupon subject to reallocation.

¹⁵¹. Ltr. Rul. 9031022 (May 7, 1990).

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Because the reacquired debt proceeds were used to acquire an interest in a partnership, the passthrough entity tracing rules of IRS Notice 89-35 applied. *H* was therefore required to reallocate the debt proceeds among the assets of *P1* and *P2* using any reasonable method of allocation. The interest would then be deductible in accordance with the nature of the partnership assets to which the debt proceeds attached. For example, to the extent debt proceeds attach to assets producing portfolio income, interest paid by *H* would be investment interest. Similarly, to the extent debt proceeds attached to assets used in the rental activity, interest paid on such debt would be passive. The IRS concluded its analysis by saying that the mere fact that debt is incurred in connection with a transfer incident to a divorce does not operate automatically to make it personal interest.¹⁵²

Contributions to Capital

There appears to be only one ruling involving contributions to capital of a partnership.¹⁵³ That may be because the purchase of an interest from the entity itself using borrowed money is clearly a contribution to capital. Thus, if an individual borrows money to purchase from the partnership itself an interest in a limited partnership, (1) there is an increase in the individual's equity interest in the partnership, and (2) it is the partnership that winds up with the money.

In the ruling, a nongrantor trust holds assets consisting primarily of real estate located in several states. The real estate apparently had debt associated with it. Upon termination of the trust, the assets are to be distributed among the beneficiaries, but disproportionate distributions are permitted, which the trust intended to do. Under the termination plan, the trust formed a single-member LLC of which it was the sole member. The LLC was a disregarded entity, so the LLC's activities remained taxable to the trust.

The trust transferred assets to the LLC, which also became a co-debtor with the trust on debt encumbering the transferred assets. The trust also borrowed money against trust assets, but none of the borrowed money was transferred to the LLC. In termination, some beneficiaries received a mixture of cash and property; some a mixture of cash and interests in the LLC; and a few received only cash. The ruling requested was that the beneficiary-partners of the LLC be permitted to deduct interest paid by the LLC as investment interest.

The IRS began by saying that the distribution of the LLC interest from the trust to the beneficiaries resulted in the disregarded entity becoming a partnership. Citing a revenue ruling,¹⁵⁴ the IRS said that the beneficiaries would therefore be treated upon distribution of the membership interests as having received proportionate shares of the LLC's assets subject to proportionate shares of its liabilities, and then immediately thereafter contributing those debt-encumbered assets to a new partnership in exchange for interests in the new partnership. Because the partnership receives property subject to debt, but receives no cash distributions of that debt, the partnership is treated as constructively borrowing the remaining debt on the property and investing that same amount in the property.¹⁵⁵ The assumed debt, therefore, is entirely allocable to those partnership assets. Because the assets are investment assets, the partnership is entitled to deduct interest on the debt as investment interest in accordance with the rules governing investment interest.

¹⁵². See *Seymour v. Comm'r*, 109 TC 279 (1997). The Tax Court rejected the IRS's argument that interest paid on debt to buy out wife's interest in assets as a result of their divorce was nondeductible personal interest, but was instead deductible or not in accordance with the tracing rules.

¹⁵³. Ltr. Rul. 200613025 (Dec. 14, 2005).

¹⁵⁴. Rev. Rul. 99-5, 1999-1 CB 434.

¹⁵⁵. Citing Temp. Treas. Reg. §1.163-8T(c)(3)(ii).

The ruling requested was whether it would be reasonable to allocate the debt among the investment assets using ratios of their FMVs. Citing IRS Notice 85-35, the IRS stated that, in the case of debt proceeds treated as a contribution to capital, the debt is to be allocated among the entity's assets using any reasonable method. The IRS concluded that the proposed method was reasonable.¹⁵⁶

Observation. Contrast this ruling with the ruling involving distribution of S corporation stock from an ESBT. In that ruling, the entity (the S corporation) was already in existence. The debt assumed by the shareholders was therefore for purposes of acquiring the shares. As a result of the debt, the redeemed beneficiaries received the money, not the S corporation, and the beneficiaries who became shareholders thereby increased their equity interests in the S corporation. The partnership ruling, however, involves the creation of a new entity that acquired assets that were purchased in part with borrowed money. Because the debt remained with the assets and the assets were transferred to the entity, no person other than the partnership could be said to have received any of the debt proceeds, which makes it a contribution to capital.

This ruling involved the formation of a new partnership using encumbered assets. An existing partnership that incurs debt to acquire assets simply uses the tracing rules to allocate debt to the acquired assets. Furthermore, the ruling focused on allocation of that debt rather than the type of debt-financed transaction that was involved. Another letter ruling dealing with S corporations may help to add light to this issue.

In the ruling, an S corporation borrowed money and used the debt to build a building used in its business.¹⁵⁷ The debt was secured by a mortgage on the building. To increase their debt basis, the shareholders personally assumed the corporation's loan and mortgage. (Presumably this meant they were assuming the corporation's loan from the bank and the corporation was becoming indebted to them — in other words, a back-to-back loan.) Because the corporation had been the recipient of the original debt proceeds and the use of those debt proceeds was not going to change, the IRS ruled that the assumption of the loan by the shareholders would be treated as a debt-financed acquisition of an interest that was a contribution to capital. The debt would therefore remain allocated to the building.

ALLOCATION OF DEBT AMONG ASSETS

For debt-financed acquisitions that are not contributions to capital, the debt proceeds are to be allocated among all the assets of the entity using any reasonable method. According to IRS Notice 89-35, reasonable methods ordinarily include a pro rata allocation based on the FMV, book value, or adjusted bases of the assets. In determining the ratios, appropriate reductions must be made for any debt of either the entity or the owners that has already been allocated to any assets.

Examples of how the debt allocation rules actually work in the case of acquisitions that are not capital contributions are illustrated by two letter rulings. In the first one, involving a stock redemption, the IRS ruled that the following proposed allocation method represented a reasonable method under IRS Notice 89-35.¹⁵⁸

1. At the end of each month, the book value of the corporation's assets will be segregated into classes identified as business assets, passive activity assets, investment assets, and personal assets.
2. A ratio equal to the total book value of assets in each class identified in step 1 to the total book value of all assets will be compared each month.
3. Finally, an average ratio for the entire year will be computed based on the number of months in the taxable year of the taxpayer.

¹⁵⁶. Ltr. Rul. 200613025 (Dec. 14, 2005).

¹⁵⁷. Ltr. Rul. 8949091 (Sep. 14, 1989).

¹⁵⁸. Ltr. Rul. 9116008 (Jan. 10, 1991).

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Allocations for debt-financed acquisitions that are contributions to capital may apparently be done in the same manner as acquisitions that are not contributions. In addition, IRS Notice 89-35 permits such debt to be allocated using the normal tracing rules of the temporary regulations. Normally, one would want to choose the allocation method providing the most favorable benefit to the partners, assuming that switching between methods would not be interpreted as being unreasonable. There are no letter rulings on this type of allocation. The following is a simple example to show the significance of the method chosen.

Example 33. The partners of a partnership borrow \$100 from an unrelated bank and lend it to the partnership to be used for the construction of a building that will be used in the partnership's active trade or business. In addition, the partnership has \$100 worth of investment assets.

If the proportionate allocation rules are used, half the debt must be allocated to the building and half to the investment assets. If the tracing method is used, all the debt can be allocated to the building.

IRS Notice 89-35 requires debt to be allocated among **all** assets of the partnership unless the tracing approach is properly being used. Although there is no direct authority, it would seem that this approach should therefore include not only the physical assets of the partnership, but also its intangible assets. However, equipment depreciated under modified accelerated cost recovery system (MACRS) may have little or no basis. As a **general rule**, therefore, one would want to use FMV for allocations of debt in a partnership or S corporation conducting an active trade or business, as this will usually result in a larger business interest deduction and minimize that portion of debt allocable to investment or other non-business assets.

In classifying assets, bank accounts are always treated as investment assets regardless of whether they are interest bearing or are working capital. Accounts receivable generated by a partnership as a normal part of its trade or business are treated as business assets, however.¹⁵⁹

If a debt-financed acquisition is treated as a contribution to the capital of the partnership and the debt is allocated using the tracing rules rather than proportionately among all the partnership assets, applying the reallocation rule should be relatively easy. Because the debt is allocated to assets that were created by the debt, only those assets need to be tracked and there is no requirement to determine the FMV, book value, or adjusted basis of assets.

Determining when there should be a reallocation of debt that has been allocated under the pro rata rule is more difficult. All IRS Notice 89-35 says is that such proceeds shall be reallocated among the assets of the entity as the assets of such entity, or the use of such assets, changes. Taken literally this would be a nightmare, as the values of assets to which debt has been allocated could change daily, such as inventory or balances in bank accounts. There should therefore be some threshold, below which changes would not be deemed significant enough to require reallocation, commonly referred to as a **de minimis rule**.

There does appear to be some authority for a de minimis rule in one letter ruling.¹⁶⁰ In this ruling, which involved a corporate split-off, the S corporation to be divided conducted a commercial real estate business consisting of three commercial buildings and an apartment building. The ruling does not say how many of those buildings the parent corporation (the subject of the ruling) retained following the split-off but it appears to be more than one.

The corporation's proposal to allocate its debt using a ratio based on FMVs of assets determined at the end of each taxable year was acceptable to the IRS. The IRS stated, however, that the debt would have to be reallocated during the taxable year anytime there was a significant change in the assets of the corporation. The ruling defined "significant change" to mean a sale or other disposition of any of the corporation's commercial buildings or if there was otherwise a 15% change in the corporation's assets, determined on the basis of FMV.

¹⁵⁹. TAM 200010004 (Sep. 21, 1999).

¹⁶⁰. Ltr. Rul. 9441025 (Jul. 11, 1994).

Because the corporation possessed only a few commercial buildings, a disposition of any of them would certainly seem to be a significant change. But, what if one of the buildings made up only 10% of the total FMV of values? Under the 15% rule this would seem not to be significant. It does not seem unreasonable, therefore, to use the following rules for determining when a significant change in FMV has occurred requiring a reallocation calculation.

1. If a single asset has a FMV that is 15% or more of the value of total assets, its sale or other disposition or a 15% or more change in its FMV is a significant change.
2. Assets individually having a FMV less than 15% of the FMV of total assets are grouped by activity (trade or business, passive activity, etc.). If there is a 15% or more change in FMV of the **group** in any class, it is a significant change.

Note. Although the ruling focused on allocating interest expense based on the values of assets owned by two S corporations, nothing in the opinion prevents its application to partnerships, apart from the limitation imposed by IRC §6110(k)(3) to parties addressed in the ruling.

The next question is how one keeps track of the values of all assets and how often grouped assets must be revalued to see if there has been a significant change. It is probable the IRS would say it is dependent on facts and circumstances. For example, if a corporation has grouped assets that tend not to be disposed of and the values of which tend to be relatively stable, it might be enough to revalue only once a year or even as necessitated by facts and circumstances, such as an expected increase or decrease in values of assets of that kind in that area. Except in the case of individual assets that are 15% or more of the value of all assets, it would seem unreasonable to require revaluations more than once a month.

If a taxpayer is using ratios of book value or adjusted basis for allocating debt, the determination of whether there has been a significant change could probably be made on the basis of book value or adjusted basis, though exactly how this would be done and whether 15% would be a reasonable de minimis amount are open to question. It certainly would be easier to track changes, because original book value and basis are more objective numbers than FMV.

REPORTING

Note. The following reporting rules were promulgated prior to the TCJA and may be affected by that act as well as any sunset provisions. References to lines and columns on forms are based on 2022 forms. Return preparation software should handle proper reporting on forms if the practitioners input data properly.

Individuals should report interest expense paid or incurred in connection with debt-financed acquisitions on either Schedule E, *Supplemental Income and Loss*, or Schedule A, *Itemized Deductions*, of Form 1040, *U.S. Individual Income Tax Return*, depending on the type of expenditure to which the interest expense is allocated. An interest expense is considered allocated to a particular expenditure of a passthrough entity if the interest expense is allocated to such expenditure under the tracing rules of Temp. Treas. Reg. §1.163-8T and IRS Notice 89-35. In addition, any interest expense allocated under the rules of IRS Notice 89-35 to assets used in an activity must be treated for reporting by individuals in the same manner as interest expense allocated to an expenditure for such assets would be treated.

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Trade or Business Expenditures¹⁶¹

Interest expense allocated to a trade or business expenditure of a passthrough entity should be reported in part II of Schedule E. This interest expense should be identified on a separate line in column (a) as business interest, followed by the name of the passthrough entity to which the interest expense relates. The amount of such interest expense should be entered in column (i). This interest expense is generally deductible and should not be entered on Form 8582, *Passive Activity Loss Limitations*, or Form 4952, *Investment Interest Expense Deduction*.

Note. Listing interest as a trade or business expenditure necessarily assumes there is material participation. If there is not, the interest should be treated as a passive activity expenditure.

Passive Activity Expenditures

Interest expense allocated to a passive activity expenditure of a passthrough entity should be entered on Form 8582 as a deduction from the activity in which such expenditure was made. The deductible amount of such interest expense, if any, as determined under the passive activity regulations, should be reported in part II of Schedule E.¹⁶² This interest expense should be identified on a separate line in column (a) as passive interest, followed by the name of the passthrough entity to which the interest expense relates, and the amount of such interest expense should be entered in column (g).

Investment Expenditures

Interest expense allocated to an investment expenditure of a passthrough entity should be entered on Form 4952.¹⁶³ Any deductible amount allocated to **royalties** should be entered on a separate line of Schedule E, part II. Practitioners should enter "investment interest" and the name of the entity in column (a) and the amount in column (i).¹⁶⁴ The deductible amount (if any) of such interest expense should be reported on line 9 of Schedule A or on Schedule E in accordance with the instructions for Form 4952 or, if appropriate, on Schedule A without being entered on Form 4952. The balance of the deductible amount is reported on Schedule A, line 9.

Personal Expenditures

Interest expense allocated to a personal expenditure made by a passthrough entity for or on behalf of the owner is not deductible.

Debt-Financed Distributions

Unless the optional allocation rule is used, debt of passthrough entities and the associated interest expense must be allocated under the rules of Temp. Treas. Reg. §1.163-8T. In general, when debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense are to be allocated under Temp. Treas. Reg. §1.163-8T in accordance with the **owner's** use of the debt proceeds. For example, if the owner uses distributed debt proceeds to purchase an interest in a passive activity, the owner's share of the interest expense on the debt proceeds is allocated to a passive activity.

¹⁶¹. Instructions for Schedule E.

¹⁶². Ibid.

¹⁶³. Instructions for Form 4952.

¹⁶⁴. Instructions for Schedule E.

An owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners may exceed the entity's interest expense on the portion of the debt proceeds distributed to that particular owner.¹⁶⁵ In such cases, the entity must allocate the owner's excess interest expense using any reasonable method. The determination of whether a particular method of allocating such excess interest expense is reasonable depends on the facts and circumstances, including whether the entity consistently applies the method from year to year.

Under the **optional allocation rule**, a passthrough entity may allocate distributed debt proceeds and the associated interest expense to one or more expenditures (other than distributions) of the entity that are made during the same tax year of the entity as the distribution to the extent that debt proceeds (including other distributed debt proceeds) are not otherwise allocated to such expenditures.¹⁶⁶ However, distributed debt proceeds must be allocated under the general allocation rule to distributions to owners of the entity to the extent that they exceed the entity's expenditures (other than distributions) for the taxable year. Once debt proceeds are allocated under the optional rule, the debt proceeds must be reallocated, when necessary, under the general reallocation rule of Temp. Treas. Reg. §1.163-8T.

Any repayment of debt of a passthrough entity allocated to distributions to owners of the entity and to one or more other expenditures may, at the option of the passthrough entity, be treated first as a repayment of the portion of the debt allocated to such distributions.¹⁶⁷

To the extent debt proceeds of a passthrough entity are allocated to distributions to owners of the entity, the portion of an owner's share of the entity's interest expense on debt proceeds allocated to the owner that does not exceed the entity's interest expense on the portion of the debt proceeds distributed to such owner should be included with code W in box 13 on Schedule K-1 for other deductions. This interest expense should be identified on an attached schedule as interest expense allocated to debt-financed distributions.

The manner in which the owner should report such interest expense depends on the types of expenditures that the owner makes with the distributed debt proceeds. For example, if the owner uses the debt proceeds to make a personal expenditure, the debt is personal debt and the owner cannot deduct the interest.

To the extent an owner's share of a passthrough entity's interest expense on debt proceeds allocated to distributions to owners exceeds the entity's interest expense on the portion of the debt proceeds distributed to such owner, the excess interest expense should be reported on Schedule K-1 in a manner consistent with the allocation of such interest expense by the entity. For example, if the passthrough entity allocates the excess interest expense to a rental activity, the expense should be taken into account by the entity in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1.

If the passthrough entity uses the optional rule to allocate distributed debt proceeds and associated interest expense, the entity's interest expense on debt proceeds allocated to the other expenditures should be reported on Schedule K-1 in a manner consistent with the allocation of the debt proceeds. For example, if the passthrough entity allocates distributed debt and the associated interest expense to an expenditure in connection with a rental activity, the entity should take the interest expense on the debt into account in computing the income or loss from the rental activity that is reported to the owner on Schedule K-1.

¹⁶⁵. Prop. Treas. Reg. §1.163-14(d)(1)(ii); IRS Notice 88-37, 1988-1 CB 522.

¹⁶⁶. IRS Notice 89-35, 1989-1 CB 675.

¹⁶⁷. Ibid.

CASE STUDY

There is an interesting Tax Court opinion involving both debt-financed distributions and debt-financed acquisitions of interests in partnerships.¹⁶⁸ This is a reviewed opinion and provides an excellent illustration of the application of IRS Notice 89-35 to partnerships.

Maurice was a partner in three rental real estate partnerships for many years. In 2009, the three partnerships borrowed millions of dollars through loans secured by their properties. They then distributed significant portions of the debt proceeds to the two partners, including Maurice. The partnerships paid interest on the loans and allocated to each partner's Schedule K-1 that partner's share of the interest expense. This was a debt-financed distribution. Maurice used his share of the debt to purchase investment assets and correctly reported his share of partnership interest as investment interest on his Schedule A in accordance with the rules governing debt-financed distributions and the tracing rules. Maurice had sufficient net investment income to deduct all of the investment interest.

In 2011, Maurice gifted part of his three real estate partnership interests to his son, William, who agreed to be bound by the partnership agreements. William did not assume personal liability for any of the partnerships' debts. As a result of gifting the partnership interests to William, Maurice was relieved of related shares of the nonrecourse partnership liabilities. On his 2011 income tax return, Maurice treated this as a sale of those partnership interests and paid income tax on millions of dollars of capital gains.

Maurice also held directly small general and limited partnership interests in a fourth real estate partnership as well as a separate interest held indirectly through a family limited partnership. The real estate partnership, like the others, incurred a nonrecourse loan and used it to make debt-financed distributions to its partners, including direct and indirect distributions to Maurice. Maurice used these distributions to acquire investment assets, which he held until his death. As with the other partnerships, Maurice received a Schedule K-1 with his share of the partnership's interest on the loan and treated it as investment interest on his individual return.

Maurice died in 2013. William inherited Maurice's general and limited partnership interests in the fourth real estate partnership and part of his interest in the family limited partnership. William did not assume personal responsibility for any of the partnership's debt.

Once William was a partner in these partnerships, he began receiving Schedules K-1 with his share of interest on the still outstanding loans. However, William had no investment assets and had never received any of the loan proceeds upon which interest was being paid by the partnerships. He treated the interest as having been paid on indebtedness properly allocable to the partnerships' rental real estate assets and deducted the interest expense against his distributive shares of the partnerships' real estate income. He did this on Schedule E by netting against the income for each partnership the corresponding amount of interest expense, reporting only the net income on his Form 1040.

The IRS audited William and recharacterized his distributive share of partnership interest as investment interest deductible only to the extent of net investment income, of which William had none. The matter then went to Tax Court.

In court, the IRS argued that William stepped into his father's shoes so that his share of the interest remained investment interest as long as the partnerships had the loans. The Tax Court said it could find no support for this theory in the statute, regulations, or decided cases. It noted that Maurice had treated the interest correctly in accordance with the interest tracing regulations and IRS Notice 89-35. Furthermore, William had not received, directly or indirectly, any portion of the debt-financed distributions that went to Maurice. Nor did he use distributions from the partnerships to make investment expenditures. Thus, the facts that caused the interest to be investment interest in Maurice's hands did not apply to William.

¹⁶⁸ *Lipnick v. Comm'r*, 153 TC 1 (2019).

The court quoted the following from the regulations that explain how debt should be allocated where no proceeds are dispersed to a taxpayer.

If a taxpayer incurs or assumes a debt in consideration for the sale or use of property . . . or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property.¹⁶⁹

The court found that William had acquired his interests from Maurice while those interests were subject to existing indebtedness. He was treated as using his allocated share of that debt to make an expenditure for such property — his partnership interests. This constituted a debt-financed **acquisition** of an interest in a partnership in accordance with IRS Notice 89-35 rather than a debt-financed distribution. He was thus required to allocate the debt among the assets of the partnerships, which were actively managed rental real estate properties constituting trades or businesses.

The IRS also argued that the tracing rules were not applicable to this situation because William, when acquiring the partnership interests from his father, did not become personally liable on the partnerships' nonrecourse loans. The court found no support for that position. It cited a previous case¹⁷⁰ that considered whether a corporation should be considered to have assumed a liability for purposes of IRC §357(c)¹⁷¹ where a shareholder contributed to it an interest in a partnership whose assets were encumbered by nonrecourse debt. The court ruled that if the partnership interests transferred are in substance encumbered by a right of foreclosure on the partnership's real property, the corporation acquires such interests subject to those encumbrances. The court also noted that the IRS had previously taken the same position in a revenue ruling.¹⁷²

The court concluded that both the tracing rules and IRS Notice 89-35 applied to William's acquisitions of his partnership interests and sustained William's treatment of the interest expenses as correct in all respects.

Observation. The return preparers for the two taxpayers in this case did everything right. IRS Notice 89-35 is a more sophisticated and complex notice than initially meets the eye. As was demonstrated in this case, things may not always be as they appear.

¹⁶⁹. Temp. Treas. Reg. §1.163-8T(c)(3)(ii).

¹⁷⁰. *Smith v. Comm'r*, 84 TC 889 (1985), *aff'd*, 805 F.2d 1073 (D.C. Cir. 1986).

¹⁷¹. With certain exceptions, §357(c) requires recognition of gain on an otherwise nontaxable transfer under IRC §351 of assets to a corporation in exchange for stock to the extent aggregate liabilities on transferred assets exceeds aggregate bases in those assets.

¹⁷². Rev. Rul. 80-323, 1980-2 CB 124.

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PARTNERSHIPS AND SE TAX

IRS Large Business and International division currently has an active campaign targeting partners who may be misusing the limited partnership exception from the Self-Employment Contributions Act (SECA) tax to avoid payment of that tax.¹⁷³ The issue has become especially pronounced following the advent of LLCs. Unfortunately, the waters surrounding this issue remain very muddled.

IRC §1402(a) defines SE income as including a general partner's distributive share of business income from a partnership and guaranteed payments to a partner for performance of services in the partnership's trade or business. General partners are liable for SE tax on their distributive shares of the partnership's business income based solely on their status as general partners and without regard to the extent or whether they actually participate in the partnership's business.¹⁷⁴ Thus, if an LLC's members are general partners for federal tax purposes, their distributive shares of the LLC's business income are SE income unless an exclusion applies.

The partnership reports SE income to a partner on their Schedule K-1 in box 14.

651121
OMB No. 1545-0123

☐ Final K-1 ☐ Amended K-1

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

2022

For calendar year 2022, or tax year
beginning / / 2022 ending / /

Partner's Share of Income, Deductions, Credits, etc.
See separate instructions.

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

Information About the Partnership Guaranteed payments for

The partner calculates their SE tax on Schedule SE, *Self-Employment Tax*, based on the income they report on page 2 of Schedule E. These forms are reproduced on the following pages.

¹⁷³. *Large Business and International Active Campaigns*. Mar. 21, 2023. IRS. [www.irs.gov/businesses/corporations/lbi-active-campaigns] Accessed on Mar. 28, 2023.

¹⁷⁴. See *Cokes v. Comm'r*, 91 TC 222 (1988).

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SCHEDULE SE (Form 1040)

Department of the Treasury
Internal Revenue Service

Self-Employment Tax

Go to www.irs.gov/ScheduleSE for instructions and the latest information.
Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074

2022
Attachment
Sequence No. **17**

Name of person with self-employment income (as shown on Form 1040, 1040-SR, or 1040-NR)

Social security number of person
with self-employment income

Part I Self-Employment Tax

Note: If your only income subject to self-employment tax is **church employee income**, see instructions for how to report your income and the definition of church employee income.

- A** If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had \$400 or more of **other** net earnings from self-employment, check here and continue with Part I ☐

Skip lines 1a and 1b if you use the farm optional method in Part II. See instructions.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A

1a

b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH

1b ()

Skip line 2 if you use the nonfarm optional method in Part II. See instructions.

2 Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order

2

3 Combine lines 1a, 1b, and 2

3

4a If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3

4a

Note: If line 4a is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.

b If you elect one or both of the optional methods, enter the total of lines 15 and 17 here

4b

c Combine lines 4a and 4b. If less than \$400, **stop**; you don't owe self-employment tax. **Exception:** If less than \$400 and you had **church employee income**, enter -0- and continue

4c

5a Enter your **church employee income** from Form W-2. See instructions for definition of church employee income

5a

b Multiply line 5a by 92.35% (0.9235). If less than \$100, enter -0-

5b

6 Add lines 4c and 5b

6

7 Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2022

7

147,000

8a Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If \$147,000 or more, skip lines 8b through 10, and go to line 11

8a

b Unreported tips subject to social security tax from Form 4137, line 10

8b

c Wages subject to social security tax from Form 8919, line 10

8c

d Add lines 8a, 8b, and 8c

8d

9 Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11

9

10 Multiply the **smaller** of line 6 or line 9 by 12.4% (0.124)

10

11 Multiply line 6 by 2.9% (0.029)

11

12 **Self-employment tax.** Add lines 10 and 11. Enter here and on **Schedule 2 (Form 1040), line 4**

12

13 **Deduction for one-half of self-employment tax.**

Multiply line 12 by 50% (0.50). Enter here and on **Schedule 1 (Form 1040), line 15**

13

Part II Optional Methods To Figure Net Earnings (see instructions)

Farm Optional Method. You may use this method **only** if (a) your gross farm income¹ wasn't more than \$9,060, or (b) your net farm profits² were less than \$6,540.

14 Maximum income for optional methods

14

6,040

15 Enter the **smaller** of: two-thirds (²/₃) of gross farm income¹ (not less than zero) or \$6,040. Also, include this amount on line 4b above

15

Nonfarm Optional Method. You may use this method **only** if (a) your net nonfarm profits³ were less than \$6,540 and also less than 72.189% of your gross nonfarm income,⁴ and (b) you had net earnings from self-employment of at least \$400 in 2 of the prior 3 years. **Caution:** You may use this method no more than five times.

16 Subtract line 15 from line 14

16

17 Enter the **smaller** of: two-thirds (²/₃) of gross nonfarm income⁴ (not less than zero) or the amount on line 16. Also, include this amount on line 4b above

17

¹ From Sch. F, line 9; and Sch. K-1 (Form 1065), box 14, code B.

² From Sch. F, line 34; and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.

³ From Sch. C, line 31; and Sch. K-1 (Form 1065), box 14, code A.

⁴ From Sch. C, line 7; and Sch. K-1 (Form 1065), box 14, code C.

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2022

4

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Schedule E (Form 1040) 2022

Attachment Sequence No. 13

Page 2

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

Your social security number

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.**Part II Income or Loss From Partnerships and S Corporations**

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (f) on line 28 and attach **Form 6198**. See instructions.

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

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

Passive Income and Loss			Nonpassive Income and Loss		
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1	
A					
B					
C					
D					
29a Totals					
b Totals					
30 Add columns (h) and (k) of line 29a				30	
31 Add columns (g), (i), and (j) of line 29b.				31	()
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31				32	

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

Passive Income and Loss		Nonpassive Income and Loss	
(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A			
B			
34a Totals			
b Totals			
35 Add columns (d) and (f) of line 34a			35
36 Add columns (c) and (e) of line 34b			36 ()
37 Total estate and trust income or (loss). Combine lines 35 and 36			37

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs) – Residual Holder

38	(a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

- 39 Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below 39

Part V Summary

40 Net farm rental income or (loss) from Form 4835. Also, complete line 42 below	40	
41 Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5	41	
42 Reconciliation of farming and fishing income. Enter your gross farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120-S), box 17, code AD; and Schedule K-1 (Form 1041), box 14, code F. See instructions	42	
43 Reconciliation for real estate professionals. If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

Schedule E (Form 1040) 2022

IRC §1402(a)(13) excludes from SE income a limited partner's distributive share of a partnership's business income. Because the SE laws and regulations governing partners' distributive shares of partnership business income were enacted long before LLCs existed in the United States, there is presently no formal IRS guidance for determining whether a member of an LLC should, for SECA, be treated as the equivalent of a general partner or limited partner. As a result, there is a wide array of opinions concerning the extent to which LLC members should be considered general or limited partners. There is a developing body of court cases and IRS rulings addressing the issue. (Although the IRS in 1997 issued proposed regulations¹⁷⁵ on this issue, the regulations have never been finalized and have been disregarded in cases and rulings.)

The general approach taken by courts has been to examine cases in light of Congress' reason for enacting the limited partner exception from SECA and how the characteristics of limited partners under state law can best be analogized to members of LLCs. The seminal case in this regard is *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*,¹⁷⁶ in which lawyers in a law firm limited liability partnership (LLP) treated themselves as limited partners not subject to SECA on their distributive shares. The Tax Court ruled against them, noting that all the firm's income was derived from personal services performed by the partners. In determining whether they should be treated as limited partners, the court quoted from the legislative history of §1402(a)(13):

Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. The bill would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. This is to exclude for coverage purposes certain earnings which are basically of an investment nature. However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership.¹⁷⁷

The court then went on to say the following.

[T]he intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.¹⁷⁸

The Tax Court also said that, in the absence of statutory guidance on the definition of "limited partner," the term would be given its ordinary meaning. This may have led to a tendency to compare LLCs to state law definitions of limited partners.¹⁷⁹ Courts have noted such things as limited partnership laws requiring both a general and a limited partner, the requirement that a limited partnership be formally created as such, limited partners' limited liability for debts of the partnership, and a prohibition against their participation in management of the partnership on pain of reclassification as general partners (the last item no longer an issue under more recent limited partnership statutes). In those cases, however, the members of the LLCs had rights to participate in management and performed services for the LLC, both of which were the most significant factors.

¹⁷⁵. REG-209824-96 (Jan. 13, 1997) amending Treas. Reg. §1.1402(a)-2.

¹⁷⁶. *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 TC 137 (2011).

¹⁷⁷. *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 TC 137 (2011), quoting H. Rept. 95-702 (Part 1), at 11 (1977) (original emphasis added by court).

¹⁷⁸. *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 TC 137 (2011).

¹⁷⁹. See *Castigliola, et al. v. Comm'r*, TC Memo 2017-62 (Apr. 12, 2017).

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The IRS has addressed the SECA issue in two Chief Counsel Advices (CCAs). In the first, a management company organized as an LLC successor to an S corporation managed a number of investment limited partnerships for which the LLC was paid management fees.¹⁸⁰ The members of the LLC performed extensive services in managing and carrying out the trading activities of the limited partnerships as well as operational services for the LLC itself. The LLC had both voting and nonvoting membership interests, but distributive shares were allocated on the basis of total units owned without regard to class. The management company treated all its members as limited partners not subject to SE tax on their distributive shares. The only amounts reported as SE income were guaranteed payments representing health insurance premiums and parking benefits paid on behalf of the members by the LLC. However, each partner also received a Form W-2 each year, although the amounts were redacted in the CCA.

The LLC was under examination on the issue of whether their distributive shares were subject to SECA. The LLC argued that the Form W-2 wages constituted reasonable compensation for services and that each partner was therefore a limited partner with respect to their distributive shares of partnership income and not subject to SECA on those amounts.

The IRS utilized an approach similar to that in *Renkemeyer*. It noted that limited partners traditionally are passive investors who perform no role in the management or operations of the partnership. Instead, it is the general partners who do so. In this case, all the LLC members worked extensively in the LLC's business. That being the case, there was no basis for characterizing their distributive shares as a return on capital. Furthermore, relying on Rev. Rul. 69-184,¹⁸¹ holding that partners who perform services for the partnership cannot be treated as employees, and a District Court case in which members of an LLC improperly paid themselves Form W-2 wages and treated distributive shares as a non-SE return on investment,¹⁸² the IRS stated that such things as reasonable compensation for services and return on capital have no application to general partners in a partnership.

In the second CCA, an individual was a partner in an LLC that operated a number of franchise restaurants.¹⁸³ He was involved in the management and operations of the LLC on a full-time basis. The LLC had a large number of employees, many of whom had management or supervisory responsibilities. There was also an executive management team consisting of financial and operations executive employees who were not members of the LLC. The individual was paid guaranteed payments from the LLC (amounts redacted). He treated the guaranteed payments as SE income but not his distributive shares of partnership income. An IRS examiner was recommending that the distributive share be subject to SE tax.

Although admitting that the individual, as a member of the LLC, was not the equivalent of a limited partner, the LLC argued that the traditional limited partnership analysis should not apply to LLCs that derive their income from the sale of products, have made substantial capital investments, and have delegated significant management responsibility to executive-level employees. Instead, they should be treated more like corporations and permitted in cases like this to a non-SECA return on investment.

The IRS rejected the LLC's argument that an LLC classified as a partnership could combine elements of return on capital with reasonable compensation for services. Relying on the legislative history of §1402(a)(13) and *Renkemeyer*, it said that:

*Section 1402(a)(13) provides an exclusion for limited partners, not for a reasonable return on capital, and does not indicate that a partner's status as a limited partner depends on the presence of a guaranteed payment or the capital-intensive nature of the partnership's business.*¹⁸⁴

The IRS concluded that the SE exclusion was intended by Congress to apply only to those who merely invested and not to those who actively participated and performed services for a partnership in their capacity as partners.

¹⁸⁰. CCA 201436049 (May 20, 2014).

¹⁸¹. Rev. Rul. 69-184, 1969-1 CB 256.

¹⁸². *Riether v. Comm'r*, 919 F.2d 1140 (D. N.M. 2012).

¹⁸³. Ltr. Rul. 201640014 (Jun. 15, 2016).

¹⁸⁴. *Ibid*.

The Tax Court again addressed the issue of a law firm organized as an LLC where the lawyer-members failed to pay SE tax on their distributive shares of partnership income in *Castigliola, et al. v. Comm'r*.¹⁸⁵ The three members of the firm met with their long-time, experienced CPA to discuss reporting payments from their newly formed member-managed LLC. The CPA advised them that they could make guaranteed payments that would be subject to SE tax, but that distributive shares in excess of that would not be. As a result, the lawyers made guaranteed payments to themselves that the court found were comparable to local legal salaries in the area determined on the basis of a survey. The IRS treated the distributive shares in excess of the guaranteed payments as SE income and assessed an SE tax deficiency.

In Tax Court, the taxpayers contended that the limited partner exclusion at §1402(a)(13) applied to their distributive shares in excess of the guaranteed payments. Because the term “limited partner” is nowhere defined in the Code or regulations, the court employed what it termed a “well-established rule of construction” that, if a statute does not define a term, it is to be given its ordinary meaning at the time of enactment.

The court noted that its prior opinion in *Renkemeyer* had indicated that the meaning of limited partner is not necessarily confined solely to the limited partnership context. Following that approach, the court determined its first inquiry was whether a person claiming the limited partner exception held a position in a partnership entity that is functionally equivalent to that of a limited partner in a limited partnership. It then reviewed the history of limited partnership statutes in Mississippi (whose law governed) and noted that, although the limited partners under the law in effect during the years at issue permitted limited partners to have a few rights with respect to participation — such as voting on dissolution of the partnership or a sale of substantially all of its assets — nevertheless, a limited partner would lose limited liability protection if, in addition to exercising those rights, the individual participated in the control of the business. Thus, the primary characteristics of a limited partner were limited liability and lack of control of the business.

In this case, because the LLC was member-managed, each of the members had management power over the business of the LLC. There was no written operating agreement or any other evidence showing that a member’s management power was limited in any way. Furthermore, all of them actually participated in management decisions, such as collectively making decisions regarding their distributive shares, control of employees, and supervision of associates. Consequently, they would not have been treated as limited partners under the state’s limited partnership act.

Another case demonstrates how a member of an LLC actually can be treated as a limited partner. In *Hardy v. Comm'r*,¹⁸⁶ Dr. Hardy, a plastic surgeon, performed some procedures in his office, but any procedures requiring anesthesia had to be performed outside the office and employ the services of an anesthesiologist. Dr. Hardy had been performing these procedures in local hospitals, but often had difficulty getting space. Surgical procedures generally had three fee components: a fee for Dr. Hardy’s surgical services; a fee for the anesthesiologist; and a fee for the use of a surgical facility and its accompanying services. Patients paid the facility fee directly to the facility separately from Dr. Hardy’s fee for services.

To more conveniently perform day-surgery, Dr. Hardy purchased a 12.5% minority interest in an LLC that operated an outpatient surgical center. Although Dr. Hardy was a member of the LLC, he never managed it and had no day-to-day responsibilities. He did meet quarterly with other members, but had no input into management decisions. The LLC was professionally managed and directly billed patients for facility fees. The opinion did not indicate whether the LLC was member or manager managed, though given the discussion of Dr. Hardy’s role, one has the impression that the result would have been the same either way. Dr. Hardy received a distribution from the LLC regardless of whether he performed any surgeries at the surgery center. His distribution was not dependent on how many surgeries he performed and the LLC had no minimum surgery requirement in order for a member to receive a distribution.

^{185.} *Castigliola, et al. v. Comm'r*, TC Memo 2017-62 (Apr. 12, 2017).

^{186.} *Hardy v. Comm'r*, TC Memo 2017-16 (Jan. 17, 2017).

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In court, the IRS argued that Dr. Hardy was liable for SECA on his distributive share from the LLC because he performed surgeries at the surgery center and was not acting as a limited partner. The Tax Court disagreed. Unlike the lawyers in *Renkemeyer*, Dr. Hardy performed no services in the operations of the LLC itself. His distributions were based on the fees patients paid to use the facility and had no relationship to his services, for which he was separately paid by patients. His distributive share of the LLC's business income was therefore received by him in his capacity as an investor and not subject to SECA. It is notable that in *Hardy* the court did not mention state limited partnership laws, relying entirely on Dr. Hardy's lack of involvement in the LLC.

In another case involving a doctor who performed surgeries for an LLC, the Tax Court stated that it had been concluded "in *Renkemeyer* that an interest other than a limited partner interest could be treated as such for purposes of that section only if the holder is merely a passive investor in the entity who does not actively participate in the entity's business operations."¹⁸⁷

IRS PROPOSED REGULATIONS¹⁸⁸

The 1997 proposed regulations (which have never been finalized or withdrawn) apply to all entities classified as partnerships for federal tax purposes, regardless of what the entity is called under state law. To do this, the proposed regulations attempt to adopt an approach based on the relationship among the partner, the partnership, and the partnership's business. State law characterizations of whether an individual is a limited partner or otherwise do not matter.

An individual generally is treated as a limited partner under the proposed regulations unless the individual:

- Has personal liability for the debts of or claims against the partnership solely by reason of being a partner,
- Has authority to contract on behalf of the partnership under the law of the jurisdiction in which the partnership is organized, or
- Participates in the partnership's trade or business for more than 500 hours during the tax year.

If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner, meaning the individual will always be subject to SECA on their entire distributive share from all interests the individual has in the service partnership. A partner is not considered to be a service partner, however, if that partner only performs a small amount of services to or on behalf of the partnership. A small amount is not defined in the proposed regulations. The IRS refers to these as **functional tests**.

Although an individual may not be treated as a limited partner under the general rule of the proposed regulations, two special rules permit some partners to exclude all or a portion of their distributive shares from SE net earnings. The first exception permits an exclusion from SECA for an interest held by an individual who has more than one class of interest in the partnership to the extent a class of interest held by the individual would, immediately after it is acquired, qualify as a limited partnership interest under the substantial interest test. This is comparable to an individual who holds both general and limited partnership interests in the same partnership.

The second exception deals with the payment for services rule and permits an individual who participates in the partnership's trade or business for more than 500 hours still to be treated as a limited partner if the individual owns only one class of interest in a class of interests that are treated as being limited partnership interests. In such a case, the partner would have SE income in the form of a guaranteed payment to the extent necessary to compensate the partner for services to the LLC, similar to the rule applied to limited partners under existing law.

¹⁸⁷. *Joseph v. Comm'r*, TC Memo 2020-65 (May 19, 2020).

¹⁸⁸. REG-209824-96, 1997-11 IRB 19, amending Treas. Reg. §1.1402(a)-2.

Whether a class of interest is treated as a limited partnership interest is determined in the same manner for both exceptions under a **substantial interest test**.¹⁸⁹ This regulation imposes the following requirements on the particular class of interest.¹⁹⁰

- The class of interest has limited partners within the meaning of the general rule who own a substantial, continuing interest in that specific class of partnership interest; and
- Individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that class held by similarly situated partners owning that same class of interest.

A **substantial interest** in a class is determined on the basis of facts and circumstances, but ownership of 20% or more of a specific class of interest is deemed substantial.

A **class of interests** is 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.

Example 34. Anthony, Betsy, and Carl form Blackacre, LLC under the laws of their state to engage in a business that is not a service partnership. Blackacre, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of the LLC to Anthony, Betsy, and Carl in proportion to their ownership of LLC. Anthony and Carl each contribute \$10,000 for one LLC unit. Betsy contributes \$20,000 for two LLC units. Each LLC unit entitles its holder to receive 25% of LLC's tax items, including profits. Anthony does not perform services for Blackacre. Each year, however, Betsy receives a guaranteed payment of \$60,000 for 600 hours of services rendered to the LLC, and Carl receives a guaranteed payment of \$100,000 for 1,000 hours of services rendered to Blackacre. Carl also is elected LLC's manager [meaning, presumably, that the LLC is a manager-managed LLC]. Under the state's law, he has the authority to contract on behalf of LLC.¹⁹¹

Anthony is treated as a limited partner in the LLC because he is not personally liable for debts of or claims against LLC. Anthony does not have authority to contract for Blackacre, LLC under state law, and he does not participate in Blackacre's trade or business for more than 500 hours during the tax year. Therefore, Anthony's distributive share attributable to his LLC unit is excluded from his SE net earnings under §1402(a)(13).

Betsy's guaranteed payment of \$60,000 is included in her SE net earnings under §1402(a)(13). Betsy is not treated as a limited partner because, although she is not liable for debts of or claims against Blackacre and does not have authority to contract for the LLC under state law, Betsy does participate in its trade or business for more than 500 hours during the tax year. Furthermore, Betsy is not treated as a limited partner because she does not hold more than one class of interest in the LLC. Nevertheless, although she worked more than 500 hours during the year, Betsy qualifies for the exception for members holding only one class of interest for two reasons. First, she qualifies for the exception because she owns a substantial and continuing interest in Blackacre. Secondly, she has the same rights and obligations provided by the **same** class of interest that Anthony, as a limited partner, owned. In this example, Betsy's distributive share is deemed to be a return on her investment in LLC and not payment for her service to LLC. Thus, Betsy's distributive share attributable to her two LLC units is **not** SE net earnings under §1402(a)(13).

¹⁸⁹. Ibid.

¹⁹⁰. Ibid. See paragraph (6)(i).

¹⁹¹. Based on an example in the Proposed Regulations.

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Carl's guaranteed payment of \$100,000 is included in his SE net earnings under §1402(a). In addition, Carl's distributive share attributable to his Blackacre, LLC unit also is SE net earnings under §1402(a) because he is not a limited partner under any of the rules of the proposed regulations. Carl is not treated as a limited partner under the general rule because he has the authority under the state's law to enter into a binding contract on behalf of the LLC and because he participates in LLC's trade or business for more than 500 hours during the tax year. Carl is also not treated as a limited partner under the exception for holders of more than one class of interests because Carl does not hold more than one class of interest in LLC. Finally, Carl is not treated as a limited partner under the exception for holders of one class because he has the power to bind LLC. Thus, Carl's guaranteed payment and distributive share both are included in his SE net earnings under §1402(a).

Note. Although the regulations are proposed, the IRS has said that the regulations cannot be enforced against taxpayers. Instead, the applicable analysis is the statutory language, legislative history, and case law. Taxpayers, however, may rely on the 1997 proposed regulations. In other words, the IRS will respect a partner's status as a limited partner if the partner qualifies as a limited partner under the 1997 proposed regulations.¹⁹²

APPROACHES TO SE TAX AS APPLIED TO LLC MEMBERS

General Partner Model

If an LLC is manager-managed, it should be treated as a general partnership for tax purposes. That is because it will fail the second test: authority to contract on behalf of the partnership under the law of the jurisdiction in which the partnership is organized. Therefore, all members of a member-managed LLC should be subject to SE tax on their distributive shares of the partnership's trade or business income, regardless of their degree of participation.

Limited Partner Model

In a manager-managed LLC, only the managing members have the right to conduct the affairs of the LLC and to bind the LLC to contracts. Nonmanaging members have no such rights. An arrangement such as this is analogous to a limited partnership under state law. The managing member serves the same function as the general partner and the nonmanaging members fill the roles of limited partners. This model is also, with the exception of service partnerships, effectively treated by the proposed regulations as a limited partnership.

If one wanted to create an LLC with the greatest chance of having some distributive shares exempt from SE tax, the limited partnership model probably has the best chance. In fact, this was essentially the approach taken by the 1997 proposed regulations. To make it resemble a limited partnership as much as possible, the LLC could be structured with two classes of members, such as class A and class B. The managing members would be class A members and would hold their management positions by virtue of the type of membership interest owned and not as a result of election. Nonmanaging members would be class B members and would have no right to participate in the selection of management members except under circumstances, such as death or withdrawal of a class A member, as would traditionally permit limited partners to choose a new general partner under limited partnership law. The managers should have small membership interests, such as 1%, and be paid guaranteed payments for their services. In addition, the managers should own nonmanaging membership interests. This would be the equivalent of a general partner who is also a limited partner.

¹⁹² *Self-Employment Tax and Partners*, p. 19. Feb. 13, 2019. IRS. [www.irs.gov/pub/irs-utl/pst_c_366_01_01_01.pdf] Accessed Mar, 29, 2023.

Although the proposed regulations require members of a service partnership to treat all distributive shares as SE income without the possibility of limited partnership treatment, this is an unreasonable approach. This is apparently based on an IRS view that personal service businesses are not permitted to operate in limited partnership form under state law and therefore should not be permitted to be treated as such for purposes of SECA. They cite nothing in support of this contention, however. A professional service provider will always have personal liability under state law for their own malfeasance no matter what the form of entity is. S corporations already give such individuals the ability to have the equivalent of limited partner protection (to the extent it can be had in such circumstances) plus the ability to pay non-SECA distributions in addition to the payment of FICA wages for services.

The assumption really appears to be that all distributive income is the result of the personal services of the members, and that there can be no return on capital. This might arguably be the case if all services of the LLC are furnished only by its members, such as was the case in *Renkemeyer*.¹⁹³ This is not always the case, however. Instead, income is also derived from employees, who are as much capital as any fixed asset for purposes of generation of income and return on capital investment.

DISCUSSION

Much of the discussion of the *Renkemeyer* case concerns the extent to which the limited partnership interest exception remains available. William O'Shea, director of the pass-through group at Deloitte Tax LLP's National Tax Office and former IRS associate chief counsel for passthroughs and special industries was quoted in an article in *Tax Notes Today* (subscription service) as saying that, under *Renkemeyer*, even limited partners under state law are not safe in that they may not meet the limited partner exception under §1402(a)(13).¹⁹⁴ In fact, *Renkemeyer* may be as much an application of an extreme case. None of the partners paid SE tax, inviting the IRS and the Tax Court to recharacterize everything.

One of the problems with drawing limited partner conclusions from *Renkemeyer* is that it was an LLP, not a limited LLP. In other words, it was a Kansas general partnership which had made a limited liability election. That did not make it a limited partnership under Kansas law; it remained a general partnership. The Tax Court pointed this out in its opinion, but commentators seem to have ignored that.

IRC §1402(a) includes as an individual's SE net earnings, plus

*[H]is distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member.*¹⁹⁵

Both the regulations and cases have said that the lack of a partner's participation in the business is irrelevant in determining whether a distributive share of partnership profit should be treated as SE net earnings. It is the status as a general partner that matters, not the extent of participation.

The *Renkemeyer* court could simply have held that the partners' statuses as general partners under Kansas law was also binding for federal income tax purposes and left it at that. The court's analysis of the limited partner exception appeared to have more to do with rebutting the appropriateness of the partnership's limited partnership exception argument. In that respect, the court appears to have done a commendable job.

In the *Riether* case, although not actually discussed, it appears the LLC there was also member-managed.¹⁹⁶ If so, the court was correct: all of the distributive share of business income should have been subject to SE tax because the two members should have been treated as general partners.

¹⁹³. *Renkemeyer, Campbell & Weaver, LLP v. Comm'r*, 136 TC 137 (2011).

¹⁹⁴. *Renkemeyer Rationale Consistent With Statute, IRS Official Says*. May 26, 2011. Elliott, Amy S. Tax Analysts. [www.taxnotes.com/tax-notes-today-federal/partnership-taxation/renkemeyer-rationale-consistent-statute-irs-official-says/2011/05/26/vx0n?highlight=Doc%202011-11386] Accessed on Apr. 20, 2023.

¹⁹⁵. IRC §1402(a).

¹⁹⁶. *Riether v. Comm'r*, 919 F.2d 1140 (D. N.M. 2012).

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The original point of the limited partner exception was to prevent individuals from making passive investments in partnerships to earn social security retirement credit without working for it. This was contrary to the underlying philosophy of social security retirement being earned by the performance of work. For a similar reason, net earnings from rental real estate, although trade or business income for income tax purposes, is excluded from qualifying for social security retirement credit.

The cases and IRS CCAs seem to be situations of bad facts making bad law. It has been clearly recognized in S corporation cases that, even if there is a personal service activity, an S corporation shareholder is entitled to a non-compensatory distributive share of S corporation business income as a return on capital when capital is a material income-producing factor and the shareholder otherwise receives reasonable compensation for services. This was true in *David E. Watson, P.C. v. U.S.*¹⁹⁷

In this case, a CPA firm had four CPAs whose partnership interests in the practice were held through individual S corporations. The firm had more than 25 associates who billed time. Watson's S corporation paid him \$24,000 in salary each year and \$204,000 and \$175,000 in distributions in each of the two years under examination. The court accepted the IRS's expert witness testimony that reasonable compensation for Watson's services — independent of any return on capital — was \$91,000 each year. The District Court sustained an IRS recharacterization of a portion of the distributions as wages. However, that still left \$137,000 and \$108,000 each year as distributions.

A similar fact pattern has not yet emerged in the LLC context, although the court in *Castigliola* noted that the partners supervised associates. Yet, even §1402(a)(13) and its legislative history seem to acknowledge that, for limited partners, there can be a bifurcation between a portion of a distributive share representing return on investment and SE income. Outside of personal service activities it might be much easier to persuade the IRS that a limited partnership type membership interest represents an investment interest without — as in *Hardy* — having to be totally passive, but instead permitting a reasonable return on investment.

Based on the analyses in the authorities, it is becoming clear that members of LLCs who participate in management or the LLC's business can expect to be treated by the IRS as the equivalent of general partners whose distributive shares of the LLC's business income is subject to SE tax. This is especially true for personal service LLCs. Regardless of whether the LLC's business is personal services, however, it is equally clear that neither the IRS nor the courts are to this point accepting arguments that any portion of the distributive share of an LLC member who is found to be more than a passive investor can be excluded from SE tax on the basis of return of capital or investment. For the time being, the only way to achieve that may be by using S corporations or structuring a non-personal service LLC as the equivalent of a limited partnership.

¹⁹⁷. *David E. Watson, P.C. v. U.S.*, 668 F.3d 1008 (8th Cir. 2012), *cert denied*, 133 S.Ct. 364 (2012), *aff'g* 757 F.Supp.2d 877 (S.D. Ia. 2010).