National Society of Tax Professionals

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Introduction to the Federal Income Tax Issues of Partnership Taxation and the Preparation of Form 1065

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I. Course Objectives

A. Variations on a Theme: Types of Business Entities

1. When taxpayers decide to enter into a trade or business for profit there are often questions and confusion as to the type of business entity that should be selected.

2. Both tax and business goals need to be determined in order to resolve the “type of business entity” dilemma.

3. The individual owners of the entity should be evaluated because their personal objectives may be different than the business objectives that are desired to be reached. In many cases the tax professional will have owners who are not “rule followers” and those type of owners believe that they can do anything they want at any time they want since the business “belongs to them.”

4. Many owners of small businesses will move money in and out of the entity freely without realizing or considering the legal and tax ramifications. At times owners will use or withdraw non-cash assets without realizing and understanding the tax and legal issues that could be at stake.

5. Many owners of small businesses do not recognize the importance of recording proper bookkeeping and accounting transactions. Many of these owners leave these issues until the end of the year and even worse not until the time an income tax return is required to be filed. Sometimes they wait until the presentation of financial data is needed for purposes of obtaining a loan or a lease.

   In many cases these owners do nothing to determine the true financial results until they receive a notice from the IRS or some other taxing authority.

6. The mindset of a small business owner is that they are in charge of everything and are not subject to any type of compliance.

B. Formation and Operation Considerations

1. The proper type of business entity needs to be considered in all stages of a business’s “life cycle.”

2. When assisting in the selection of the type of entity at formation the tax professional will need to consider owner personalities and various tax ramifications including:
a. Income taxes  
b. Local gross receipts taxes  
c. Licensing costs  
d. Personal property tax  
e. Capitalization taxes, etc.

3. The tax issues could impact the entity itself as well as the individual owner(s). If the entity will be profitable in its initial year or years then the issue of entity and/or individual income taxes must be discussed with the owner(s) in order to illustrate differences in rate structures in a graduated income tax system.

4. The income tax issues of “distributions” must be discussed in order for the owner(s) to understand that some, all, or none of the distribution will have tax imposed at their individual income tax level.

   • Most owners of a partnership don’t understand that they do not receive a salary.

5. If the entity incurs a loss for the year, then the owners need to be informed that the loss could be available to them at the individual tax return level or could be “locked in” at the entity level.

6. If the losses that are generated are “passed through” by the entity to the owners, then the owners need to be aware that the losses may or may not be available to them due to limitations imposed because of:

   a. Limited liability protections  
   b. Basis limitations  
   c. Passive activity limitations  
   d. At-risk limitations

7. During the formation stages of creating the entity, costs that are incurred could be required to be capitalized and amortized and, therefore, not deductible in the year the money is actually spent. This is an issue and a concept not readily understood by a small business owner.

8. In other cases during formation some costs must be capitalized and are not amortizable. These costs are recovered only at the time the entity ceases to exist.

9. Fixed assets costs are separate issues and deductibility depends on a statutory life of an asset as determined by the Internal Revenue Code (IRC). While an election is available to perhaps “expense” a “qualifying asset” there are limitations imposed on this treatment. In addition, the owner(s) should be aware that the use
of a current year deduction could have a reduced effect if entity or individual income tax rates will be greater in a subsequent year. The impact of self-employment taxes will also need to be considered.

10. Another tax issue that must be considered at the time of formation is the impact of the transfer of an individual owner’s assets to the entity. Questions as to entity and individual taxes arise as well as the bases of the assets in the hands of the entity and the holding periods involved.

11. When assets are transferred by the owner to the entity the owner needs to understand that the assets are then owned by the entity and in exchange the owner receives “rights” to certain interests. Therefore a tangible asset is exchanged for an intangible asset.

12. The transfer of the assets gives the owners “rights” to profits, losses, distributions and liquidations but only at the time and conditions stated in or set by the entity agreement whether in written form or in an oral understanding depending on the type of entity created.

C. Types, Additions, and Deletion of Owners

1. It is important that the tax professional discuss with the owners of the business entity that different formations allow or restrict the type of ownership permissible.

2. Some entities are permitted to allow any “person” to have an ownership interest. Therefore, the “person” could be an individual taxpayer as well as another entity type such as a corporation or a trust.

3. Other entities are more restrictive and will not permit ownership by certain “persons” such as a corporation or a foreign person or entity.

4. When ownership of the entity changes, the impact of how it is changing is important because the ownership change may be the result of the entity itself offering additional interest or the ownership could be a transaction which takes place outside of the entity by a buying and selling owner.

D. Liquidation of an Ownership Interest

1. Ownership interest could cease because the entity itself ceases to exist or because an owner disposes of some or all of the ownership interest of the entity.

2. When there is a liquidation of the entity itself the entity ceases to be an operating company for purposes of being in a trade or business and the assets will need to be either:
a. Liquidated with the net proceeds being distributed out to the owners after the creditors’ claims have been satisfied, or

b. The assets and liabilities will be distributed directly to the owners of the entity.
   - In exchange for the net proceeds or other assets the “persons” will transfer the “rights” of ownership back to the liquidating entity.

3. The tax implications to both the entity and the owner(s) will depend on the type of entity in existence at the time of the final transactions.

4. In some situations both parties could be required to recognize taxable events or it could be that no income is recognized by either party to the transaction.

5. The basis of individual assets at the entity level will play an important role as will the basis of the owner’s interest.

6. If the liquidation of an individual owner is the result of a transaction outside of the entity, then that owner would need to account for that transaction as outside of the entity. The owner’s basis will become an important factor in determining the individual tax impact.

E. Changes in the Form of Entity

1. After a company has been formed and is in an operating mode it may be necessary for the operation to change the type of entity.

2. This may occur because of the desire to:
   a. Raise capital.
   b. Reduce exposure to creditors.
   c. Change the allocation of profits and losses.
   d. Allow for different types of ownership rights.
   e. Allow ownership by restricted types of owners.
   f. Remove an existing owner or owners.

3. If a change in the type of business entity is an issue, then the tax professional must inform the existing entity and its owners that there could be income tax ramifications to both parties.
4. A change could cause a liquidation of the entity causing:
   a. Recognition of income.
   b. Changes in basis.
   c. Changes in holding periods.
   d. Debt relief.
   e. Loss of carryforwards.

5. On the other hand a change could cause a nonrecognition of income or loss thereby causing a retention of basis, holding periods and continuation of carryforwards. This may not be a goal of the conversion.

6. Careful analysis should be performed before a change in the type of entity takes place for an ongoing operation.

F. Focus of This Course

1. The focus of this outline is to introduce the tax professional to the general concepts of the Limited Liability Company (LLC) and the General Partnership (GP).

2. The unique features of the LLC are that it will allow a “blend” of all other legal business entities that the owner has available while generally being treated as a General Partnership (GP) for federal income tax purposes if there are two or more owners under the default rules of the IRS “check-the-box” regulations.

3. The introduction to the taxation rules for a GP will be discussed while reviewing the reporting requirements of IRS Form 1065 and the related Schedule K-1.

4. In discussing a one person LLC the concept of a “disregarded entity” will be reviewed. Under the default provisions of the IRS “check-the-box” regulations, a one person LLC will be a “disregarded entity” and for federal income tax purposes be treated as a “sole proprietorship,” therefore requiring the filing of a Schedule C on Form 1040.

II. Introduction to the Limited Liability Company (LLC)

A. Qualities of an LLC

1. A limited liability company (LLC) is a business entity that combines several of the favorable attributes of other forms of business entities.

2. An LLC is a hybrid entity.
3. It is treated **like a corporation** for purposes of **limited liability** of the owners.

4. Generally, it is treated **like a general partnership for federal income tax** purposes. Therefore, a Form 1065 is filed and all tax attributes “pass through” to the owners.

5. In 1977 Wyoming was the first state to enact the LLC. Revenue Ruling 88-76, 1988-2 C.B. 360 announced that Wyoming LLC qualified to be treated as a partnership for federal income tax purposes.

6. Since an LLC has **both** corporate and partnership characteristics, it is a hybrid entity that can be classified as **either** a partnership or corporation.

7. An LLC **allows membership control** over the day-to-day business operations **without risking general liability**.

8. An LLC has the **freedom from** the Subchapter S-Corporation **eligibility requirements**.

9. An LLC is **not restricted** as to the **number and type** of owners.

10. **Distributions of appreciated assets** to owners does **not** trigger entity level gain as it does with corporations.

11. An LLC has the flexibility to **allocate tax attributes** to its owners under §704(b) due to “substantial economic effect” just like a general partnership.

**B. Terminology of an LLC**

1. **Members:** The owners of an LLC are known as “members” (**not** shareholders and **not** partners). A member of an LLC is a “person” that has the status of a member under the state statute and the LLC’s organization and operating documents. Their ownership is described as “members’ interest” or simply “interest in the LLC.”

2. **Articles of Organization:** An LLC is formed by filing “Articles of Organization” with the state filing authority (**not** articles of Incorporation and **not** articles of Partnership).

3. **Operating Agreement:** The operating agreement is generally referred to as “regulations.” The operations of an LLC and the internal right and obligations of its members and manager are ordinarily governed by an “operating agreement” among the members which may be written or oral.
4. **Member Managed vs. Manager Managed:** Managers serve the same purpose as a corporate board of directors or general partner of a partnership. At the time of formation of an LLC, the “Articles of Organization” must indicate whether the management authority will be:

(a) Vested in one or more managers who are not required to be owners of the LLC,
Or
(b) Reserved to the members.

C. **Broader Overview of an LLC**

1. **All** states and the District of Columbia have now passed LLC legislation.

2. An LLC combines the **limited liability** of a corporation with the **flexibility** of a general partnership.

3. The LLC **avoids** the burdensome **limitations** on ownership and single class of stock rules imposed by the selection of a Subchapter S-Corporation.

4. For purposes of **federal income taxes** the general rule is that an LLC that has **more than one** member will be taxed as a **partnership**.

5. The “check-the-box” regulations provide for an **exception** to this general rule by allowing the entity to be taxed as a corporation. In order to make this election the entity will file **Form 8832** “Entity Classification Election.”

6. If the entity does not make the election then a **Form 1065** will be required to be filed giving the members the ability to allocate income and loss in any manner that has “substantial economic effect.” By being taxed as a partnership it also allows the members to include a portion of the LLC’s debt in the basis of their membership interest to the extent of guarantees by the individual member.

7. For purposes of LLC debt the member generally has limited liability. The **exceptions** to this general rule are that the member is still liable for their own misconduct and generally speaking are liable for any tax collected on behalf of a government authority such as sales taxes and payroll taxes.

8. A **single member** LLC is disregarded as an entity separate from its owner, and therefore, under the default rules is taxed as a sole-proprietorship and is required to file a **Schedule C** with their personal **Form 1040**.

9. A **single member** LLC can elect to be taxed as a corporation for federal income tax purposes by filing IRS **Form 8832**.
10. The LLC is a business entity formed under the provisions of a particular state’s LLC statute. Each LLC statute is different and each has different requirements for formation, operation and dissolution. An LLC is composed of owners called “members” who are all entitled to participate in the operation of the management.

**Tax Professional Note:** This is different than a Limited Partnership (LP) where limited partners have no management or operational authority if they desire to remain “limited” from creditor claims.

11. An LLC can elect managers to run the daily operations much like that of a general partner or officer of a corporation. Managers do not have to actually be members of the LLC. They can be outside parties hired by the member owners.

12. Because of all the various provisions in all of the statutes across the nation governing LLCs, a Uniform LLC Act has been drafted. A Uniform LLC Act will allow for default provisions to take a position if an issue is not addressed in a particular state’s statute. This will become especially important in situations where a business operates in several states.

**D. Other Issues to Consider When Discussing an LLC with Your Client**

1. Every state will charge some type of annual fee much like the corporate registration fee charged by states. Generally, there is some type of annual report which must be submitted with the fee requesting a schedule of owners, earnings, assets acquired, registered agent, etc.

2. A new business entity has little risk when forming as an LLC. However, existing business entities that convert to an LLC could have an unexpected and very costly tax trap, especially if the business being converted is an existing Subchapter C-Corporation which will cause the liquidation of the corporation. This could cause both a corporate level tax through the provisions of a “deemed sale” of assets at the corporate level with a corresponding liquidating dividend to the shareholder(s).

3. Even the conversion of a Subchapter S-Corporation could cause a corporate level gain or loss, on the deemed sale of assets, to be passed through to the shareholder(s). In addition there would be a calculation required to measure the gain or loss on the distribution of the corporate assets in exchange for the stock of the shareholders. This disposition of the closely held stock would be required to be reported on Schedule D of the shareholder’s Form 1040.
E. Formation Issues of an LLC

1. Most LLCs are created when the articles of organization are filed with the Secretary of State. The articles of organization are similar to articles of incorporation. They generally contain only broad information about the LLC such as:
   a. Name.
   b. Business purpose.
   c. Registered agent.
   d. Principal office location, etc.

2. An LLC should have an operating agreement although not required by most states. The operating agreement is similar to a general partnership agreement. It outlines the duties, rights and responsibilities of the owner members. If a written operating agreement is not drafted, then any issues among the members will default to the LLC statute in the state of formation.

3. One of the great advantages of an LLC is that there is no restriction on the type of members who can own an LLC interest. This is in contrast to a Subchapter S-Corporation which limits the type and number of owners. An LLC can raise capital from other types of entities and foreign investors.

4. As in the formation of any other entity, legal fees need to be considered. Also, some states require that an LLC publish a notice of the formation or conversion to an LLC in selected newspapers as a public notice. Any subsequent changes after formation will require the amendment of the articles of organization or operating agreement which will then create additional legal fees.

F. Capital Contributions to an LLC

1. Since an LLC will be taxed as a partnership the general rule of IRC §721 provides that no gain or loss will be recognized by the LLC or its members upon the contribution of property to the LLC in exchange for a membership interest.

2. The general rule of §721 has exceptions which could apply when contributed property is subjected to liabilities assumed by the LLC and when member services are exchanged for a capital interest in the LLC. The general rule and exception will be reviewed later under the discussion dealing with general partnership taxation.
3. If there is a contribution of property by the member subjected to a liability assumed by the LLC then the contributing member could have a taxable event if the debt assumed by the other LLC members exceeds the contributing member’s basis in the LLC interest.

4. The contributing member could recognize gain because §752 provides that any decrease in a member’s share of LLC liabilities is treated as a “deemed distribution” of cash. The topic of liabilities will be discussed under general partnership rules.

G. Member Liability for LLC Debts

1. The major advantage of an LLC is that the members are not liable for the debts of the LLC.

2. Creditors have recourse against the assets of the LLC only and not against the member’s personal assets. However, most state statutes allow members to elect to assume liabilities for some or all of the debts and obligations of the LLC.

3. In professional LLCs (and LLPs) members have liability under tort law for their own negligence or the negligence of those they directly supervise.

   They are not liable for the negligence of other members.

4. Under most state LLC laws, members have certain financial obligations to the LLC under the articles of organization, operating agreement or applicable statute. These obligations generally include obligations to:

   a. Make capital contributions under an enforceable capital contribution obligation, and

   b. Return any capital distribution prohibited by law, the articles or operating agreement.

5. Fulfillment of these obligations is generally enforceable by the LLC’s creditors. Therefore, a member has liability for any LLC debt to the extent of any financial obligation the member has to the LLC under the requirements of the articles, operating agreement or state law.

6. It is important to note that limited liability generally will not be available to members of an LLC if a general partnership converted to an LLC.

7. The members who were general partners before the conversion will still be liable for LLC debt unless they are specifically released by the credits. Generally, this is a rarity.
**Tax Professional Note:** If the members are released from LLC debt, then this would be a “deemed reduction of debt” and therefore a “deemed distribution of cash.” If the deemed distribution of cash is greater than the member’s basis, then the member would have recognition of capital gain to the extent of the excess distribution. This would require a reporting on the **Schedule D** of the member’s Form 1040.

**H. Need for Limited Liability**

1. While limited liability is a desire of everyone in business, the review of whether or not it is **necessary** is a facts and circumstances decision process.

2. Liability insurance provides protection to all businesses and, therefore, could eliminate the need to form an LLC. However, limited liability could be more of a benefit to businesses that have significant risks for exposure to high levels of entity debt.

3. The following areas of exposure should be considered when the tax professional is assisting the client in the analysis of limited liability needs:
   
a. Substantial debt with suppliers and vendors.
   
b. Employees; especially if machinery and vehicles are involved.
   
c. Hazards involved in business operations such as chemical exposure to workers and surrounding neighbors.
   
d. Product liability issues.

4. In measuring the need of operating as an LLC, the owners(s) must note that there is one potential **disadvantage** of operating as an LLC. This disadvantage is that banks and major suppliers may not be readily willing to extend credit because of the feature of “limited liability.” Because of this, creditors may require **additional collateral or a personal guarantee** from the member(s).

5. The creditors might also enter a **restrictive clause** in the loan agreement that could **limit** the amount and timing of **distributions** to the member(s) limiting the ability to receive needed funds for personal use. However, it should be noted that a loan to an LLC should not require any greater amount of collateralization than a loan made to a closely held corporation. The scope of limited liability for both types of entities should be viewed significantly the same by the potential creditor.
III. General Partnership

A. Partnership Defined

1. A general partnership is a noncorporate entity required to have two or more owners who come together to form a business.

2. The business has an intent of making a profit.

3. A partnership is deemed to exist when the parties conduct shows an intent to engage in business as a partnership.

4. Unlike a corporation, a partnership does not require formalities to exist.

5. For federal income tax purposes, §761(a) of the Code defines the term “partnership” to include a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation, trust or estate.

6. The regulations at Reg. §301.7701-1 through 3 define the term partnership under the entity classification regulations dealing with the “check-the-box” rules. Under these regulations, a partnership is a business entity, with two or more members that is not mandatorily classified as a corporation, and that has defaulted to a partnership tax status.

B. Formation

1. The forming of a general partnership does not necessarily require the filing of formal documents.

2. While it is not required, written documentation among the partners is highly recommended in order to determine the actions allowed or restricted to each of the partners if applicable.

3. A partnership is governed by a written or oral partnership agreement. This agreement can contain whatever terms the partners agree upon, providing they fall within any restrictions imposed by state law.

4. Many partnership agreements, however, do not cover all of the issues regarding the operation of a partnership. In such cases, the provisions of the state's version of the Uniform Partnership Act (UPA) will govern with respect to these issues.

5. Generally, a partner in a general partnership may participate in the management of the partnership to whatever extent allowed by the partnership agreement.
6. Day-to-day management is often vested in either the managing partner or a committee. Many decisions, however, require a majority vote by partners, and in the case of “organic acts” such as the admission of new partners or liquidation, unanimous consent may be necessary.

7. The Uniform Partnership Act defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” Uniform Partnership Act (UPA) §6(1).

8. Persons may be co-owners of property without being partners even if they share profits. UPA §7(1).

9. However, the receipt of profits from a business by a person could be evidence that the party is a partner unless such profits were received in payment for one of the following reasons:
   - Debt,
   - Wages,
   - Rent,
   - Annuity to a survivor of a deceased partner,
   - Interest on a loan, or
   - Consideration for the sale of goodwill of a business or other property. UPA §7(4).

10. As previously stated a partnership can be formed informally without a written agreement. In fact, persons may be partners who thought they were only co-owners or had some other relationship such as creditor-debtor or employer-employee.

11. There may be some severe consequences since partners have joint liability for debts of the partnership. Thus, status as a partner could result in personal liability for debts of a business venture. (UPA §15) (Minute Maid Corp. v. United Foods, 291 F. 1d 577 (5th Cir.), cert. denied, 368 U.S. 928 (1961) (defendant is partner rather than creditor, and thus liable to others for debts of venture).

12. If a partnership does exist, then each partner generally has apparent authority to bind the partnership. (UPA §9.) For this reason, it is prudent for parties conducting business together to put their oral agreements in writing, particularly with regard to the authority each individual has for representing the entity and other partners, but the agreement is not binding on a third party who has no knowledge of it.
EXAMPLE: Don and Nanette own land together for profit but do not consider themselves to be in partnership with each other.

Without Nanette's knowledge, Don contracts with Mary to sell land owned by Don and Nanette to Mary.

Nanette objects to the sale on the ground that Don had no power to convey the entire interest in the land to a third party.

If a court finds that Don and Nanette were in fact partners, then Mary can enforce the sales contract because Don, as Nanette's partner, had the power to bind Nanette contractually. (Walsh v. Ellington, 188 Mont. 367, 613 P 2d 1381 (Mont. 1980).

Tax Professional Note: An entity that is not a partnership under state law may still be taxed as a partnership, Reg. §1.761-1(a); Olmstead Hotel v. Comm'r, 11 T.C.M. 694 (1952); Rev. Rul. 64-220, 1964-2 C.B. 335.

Tax Professional Note: Whenever there is either co-ownership of property for profit, the splitting of profits, or the performance of services for profit by co-owners, tax professionals should encourage the co-owners to negotiate a written agreement specifying the owners' right and obligations vis-a-vis each other, third parties, and the entity.

Although an oral agreement is usually enforceable, it provides too much opportunity for misunderstanding.

Furthermore, a written agreement provides a good opportunity for the parties to specify the nature of the entity they intend to form (such as a partnership). However, even if the parties specify that they are not partners, a court could still find that they are partners because of the terms of the agreement.

C. Joint Undertakings Resulting in a Separate Entity for Federal Income Tax Purposes

1. A joint venture or other contractual arrangement may create a separate entity for federal income tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits.

   For example, a separate entity exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. (Reg. §301.7701-1(a) (2)).

2. However, Reg. §301.7701-1(a) (2) also states that a joint undertaking merely to share expenses does not create a separate entity for federal income tax purposes.
Examples in the Regs:

- Two or more persons jointly construct a ditch merely to drain surface water from their properties. Under this limited agreement they have **not** created a separate entity.

- Mere co-ownership of property that is maintained, kept in repair and rented or leased does **not** result in a separate entity. Therefore, if an individual owner or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops they have not necessarily created a separate entity.

3. Whether or not a partnership will exist is a matter of **all** the relevant facts and circumstances of a particular arrangement. The **Tax Court** has provided guidance as to the issues that should be considered as to the existence of a separate entity as follows:

   a. **Existence** of a partnership agreement (written or oral).
   
   b. **Representation** by the parties to others that the owners were partners.
   
   c. Parties had a **proprietary** interest in the operation’s profits and an **obligation** to share losses.
   
   d. The parties have a **right** to control the entity’s income and capital, and
   

D. **Joint Undertakings and Arrangements Not Treated as Partnerships**

1. The **Tax Court** ruled that an oral agreement under which a taxpayer and another person would share equally in the profits of the taxpayer’s fish-hauling business was **not** a partnership for federal income tax purposes. In this arrangement the taxpayer continued to exercise full control over the day-to-day operations of the business as well as over the finances. Evidence reported that the other person received only a small portion of the profits. The parties **never** filed a partnership return. Although both names appeared on the bank note for a tractor trailer, the payments were paid only by the taxpayer. (Tharp, Allen, (1989) T.C. Memo 1989-406, PH TCM, ¶89406, 57 CCH TCM 1190).

2. In another case, the taxpayer was the owner of coin-operated music machines. The gross receipts were shared with the owner of the space where the machines were placed. All expenses were borne by the taxpayer. It was ruled **not** to be a partnership because the parties shared only gross receipts and not profits and losses. (Acme Music Co., Inc. In RE, (1996 BKTCY CT PA) 78 AFTR 2d 96-5447, 196 BR 925, 96-2 USTC ¶50391).
3. In a Tax Court ruling where a mother financed her son’s farming operation it was ruled that the mother was not a partner in the son’s farming business. The son made all the business decisions and did not account to the mother and did not file a partnership return.

Mother kept no records on her own and did not get involved in the business operations. Although the son promised the mother that she would get a share of the profits, the parties never worked out what the details of the “share” would be. The Tax Court ruled that the promise of a “share” of the profits was intended to assure that Mother would be cared for in the future and that it was not intended to be a profit sharing agreement. (Vaughters, Oenia, (1988) TC Memo 1988-276 PH TCM ¶88276, 55 CCH TCM 1150.)

E. The Filing of IRS Form 1065 Does Not Always Mean There Is a Partnership

1. Despite the filing of a Form 1065 the courts have determined that a partnership did not exist and that an owner was not a partner when:

   Joint owners never intended to form a partnership, never executed a partnership agreement and only engaged in minimal business activity with respect to the property generating the income (Powell, Lulu L., (1967) TC MEMO 1967-32 PH TCM ¶67032, 26 CCH TCM 161.)

   Taxpayer who signed a bank signature card as a partner was never consulted about the preparation of the Form 1065 and never obtained an interest in the business assets. He had no voice in the management and worked for a flat “salary” plus a percentage of the gross receipts. (Ronemus, Kenneth, (1969) TC Memo 1969-1161. PH TCM ¶69161 28 CCH TCM 799.

   Taxpayer reported her share of the profits of three liquor stores as partnership income on her personal Form 1040. She did not share in the stores’ losses. She did not receive a share of the proceeds when the stores were liquidated. She never participated in managing or operating the stores. Her name never appeared in connection with the ordinary business operations of the business such as on liquor licenses, checking accounts, leases, etc. There was no partnership agreement, written or oral. It was determined that the taxpayer’s claim to shares of the stores’ profits was derived only from the loans she made. Under these facts and circumstances she was ruled to be a creditor and not a partner. (Mayer, Elizabeth, (1954) TC Memo 1954-14, PH TCM ¶54120, 13 CCH TCM 391).

F. Partnership Existed Even Though a Form 1065 Was Not Filed

1. The Courts have also determined that a partnership existed or that a taxpayer was a partner even though a Form 1065 was not filed:
A husband and wife filed a partnership certificate with the appropriate local authorities where business was created.

Commenced legal action to dissolve the partnership.

One of the spouses filed a sworn affidavit testifying to the existence of a partnership in connection with a divorce action. (Liebesman, Veronica, (1966) TC Memo 1966-88, PH TCM ¶66088, 25 CCH TCM 1203).

2. In other rulings the Tax Court stated that a partnership existed when:

   Taxpayer promised brother and sister that he would give each a 10% interest in the net profits from his real estate ventures to make up for the fact that he contributed nothing to his share of his widowed mother’s support. Letters to the brother and sister showed that the taxpayer referred to the 10% interests in his real estate ventures.

   When Taxpayer sold some of his land he instructed the purchaser to give 10% of the down payment and 10% of the proceeds from the notes to each of his siblings.

   Even though no formal written partnership agreement was originally signed by the parties a state certificate of partnership was filed by the taxpayer and his two siblings about the time the land was sold. (Elrod, Johnie Vaden, (1986) 887 TC 1046.

G. Form 1065: Filing Requirements

1. A domestic partnership must file Form 1065 unless it neither receives income nor incurs any expenditures treated as deductions or credits for federal income tax purposes.

2. Beginning in tax years starting after December 31, 2015 a partnership must file Form 1065 by the 15th day of the third month after the close of the tax year. This is tax years beginning in 2016 and after. If the due date is a Saturday, Sunday or legal holiday then the return is due on the next business day. For calendar year partnerships the due date is March 15.

3. Partnerships are permitted to use private delivery services designated by the IRS in order to meet the timely mailing as timely filed rule.

4. A partnership can receive an automatic six-month extension of time to file by filing IRS Form 7004 by the regular due date of the partnership return. For a calendar year the partnership extension due date is September 15.
5. The return must be signed by a general partner or a LLC member and the paid preparer. Also, all signatures must be manual. Signature stamps or labels are not acceptable.

6. §6031 provides a penalty under §6698 for failure to file a return by the due date plus extensions. Failure to report all information is deemed to be a failure to file. Relief is available for failure to file but only if due to reasonable cause. If there is reasonable cause then a statement must be attached to the return.

   The penalty for a failure to file is $195 times the number of partners during any part of the tax year times the number of months (or fraction thereof) that the failure continues; for a maximum of twelve months.

7. Since the Schedule K-1 is an information return §6721 and §6722 provide for penalties for:

   a. Failure to file a Schedule K-1 when due,
   b. Failure to include all information required on Schedule K-1, and
   c. Including incorrect information.

      - The penalty is $250 for each Schedule K-1. After 2014 the $250 is indexed annually to inflation in $5 increments and is currently $260.

H. Inclusion of Schedules L, M-1 and M-2

1. Form 1065, Page 2, Schedule B, Question 5 asks questions which should be answered “Yes” if the following 3 conditions are met:

   a. The partnership’s total receipts are less than $250,000,
   b. The partnership’s assets are less than $600,000, and
   c. Schedules K-1 are filed with the tax return and furnished to the partners on or before the due date (including extensions) of the Form 1065.

2. Total receipts is defined as the sum of:

   a. Gross receipts or sales on page 1 of Form 1065 line 1a; plus
   b. All other income on page 1 of the Form 1065 lines 4-7; plus
   c. Income reported on Schedule K, lines 3a, 4a, 4(b)(2) and 4c; plus
   d. Income or net gain reported on Schedule K, lines 4d (2), 4e (2), 4f, 6b and 7; plus
   e. Income or net gain reported on Form 8825 lines 2, 19 and 20a.
Recommendation to Tax Professional: It is highly recommended that these schedules are filed even though not required so that all the pieces of the puzzle can be available for subsequent tax returns when these schedules are required.

I. Self-Employment Tax Issues: §1402

1. The partners of a general partnership are subjected to self-employment taxes on their distributive share of the partnership’s operating income and their guaranteed payments if they are individual taxpayers.

2. The amount of self-employment income is reported on Schedule K-1, Box 14 of these individuals.

3. Box 14 on Schedule K-1 should be left blank for partners that are estates, trusts, corporations, exempt organization, or IRAs.

4. If the partnership is a Limited Partnership then the individual taxpayers are not subjected to the self-employment tax on their distributive share of partnership income since:
   a. They are limited partners and are not active and involved in the day-to-day operations of the partnership’s business activities and
   b. They don’t participate in management decisions.

5. Limited partners are subjected to self-employment tax on any guaranteed payments that they receive for services performed for the limited partnership since they are acting in a capacity as a third party.

6. If an LLC is being classified as a partnership then the issue arises as to whether or not the distributive share of the LLC member should be subjected to the self-employment tax.

7. Just as a guaranteed payment of a limited partner is subjected to the self-employment tax so are the guaranteed payments to an LLC member.

8. Many years ago the IRS issued proposed regulations on the issue of self-employment tax on LLC members but the 1997 Tax Act included a provision that Treasury was prohibited from issuing temporary or final regulations on this issue before July 1, 1998. However, currently no temporary or final regulations have been issued and no further guidance has been issued by the IRS or Treasury. The IRS and Treasury were severely criticized after the proposed regulations were issued and probably new regulations will not be issued until Congress addresses the issue.
9. The current IRS position is detailed in Prop. Reg. 1.1402(a)-2. The regulation states that the LLC allocated income is subjected to self-employment tax if the member:

   a. Has **personal** liability for debts.
   b. Has **authority** to contract on behalf of the LLC, or
   c. **Participates** in the LLC’s trade or business for **more than 500** hours during the LLC’s tax year.

10. While the current climate for determining the self-employment income might be uncertain, the IRS in June 2003 issued a statement that taxpayers who conform to the proposed regulation will not be challenged.

    - Therefore in taking an advance position, that **active** members of an LLC are not subjected to self-employment income, risks the assessment of significant interest and penalties.
    - Taking such a position also exposes the LLC to the risk of having the **anti-abuse** regulations invoked in order to impose the self-employment tax.
    - Tax professionals should be aware that claiming non-self-employment status for LLC members can result in the IRS arguing that the members are “limited entrepreneurs” making the cash method of accounting unavailable to the LLC.
    - Excluding a member’s LLC income from self-employment will also reduce the amount of “compensation” available for the member’s retirement plan contribution.

**Tax Professional Note:** An entity that is a Subchapter S-Corporation that can defend a “reasonable compensation” amount could have significant amounts of operating income passed through which is not subjected to self-employment inclusion.

**J. Self-Employment Tax Issues of a Service LLC**

1. **Prop. Reg. 1.1402(a)-2(h) (5)** states that even if a **service LLC member** does not have:

   a. **Personal** liability for debts.
   b. **Authority** to contract on behalf of the LLC, or
c. **Participation** in the LLC’s trade or business for **more than 500** hours during the LLC’s tax year; the LLC member’s distributive share from a **Service LLC** is still subjected to self-employment rules.

**NOTE:** A service LLC member is one who provides service to a Service LLC.

2. The regulation specially states that a **Service LLC** is one that is substantially engaged in the business that provides **services in the fields of:**

   a. Health
   b. Law
   c. Engineering
   d. Architecture
   e. Accounting
   f. Actuarial science, or
   g. Consulting

3. The regulations state that a service member is a member who provides more than de minimis services to the Service LLC.

   **NOTE:** The proposed regulations do **not** provide any examples of de minimis.

**K. Penalties**

1. **§6221** provides a general rule that the tax treatment of any partnership item shall be determined at the **partnership level.**

   - This provision includes the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

2. **§6222(a)** provides a general rule that a partner’s share of each partnership item should be reported on the partner’s return in the same manner as presented on the partnership return **Form 1065.**

3. **§6222(b)** provides that if a partner treats an item inconsistent with the treatment by the partnership then the IRS must be notified of this inconsistent treatment by filing IRS **Form 8082.**

4. **§6222(c)** provides that if a partner fails to notify the IRS then a negligence penalty may be added to the tax due.
5. In order to encourage the filing of a partnership return §6698(a) provides a general rule that, in addition to the requirements under §6031 to file a return, additional penalties can be imposed.

6. §6698(b) states that if the partnership does not file then a penalty of $195, per partner, per month (or fraction thereof) will be imposed on the partnership for failure to file a complete and timely information return.

   - The penalty cannot exceed twelve months.

7. §6231(a) (1) (B) (i) has an exception to this penalty for “small partnerships.” A “small partnership’ is defined in the Code as a partnership having ten or fewer partners each of whom is an individual (other than a nonresident alien), a C-Corporation, or an estate of a deceased partner.

   - A husband and wife are treated as one partner.

L. Capitalizable Costs: No Current Deduction

1. Certain expenditures incurred before a partnership begins the active conduct of a trade or business are capitalized and not deducted in the year paid or incurred.

2. These pre-opening expenditures generally are accounted for in three categories as follows:

   a. Organization Expenditures: §709(b)
   b. Start-Up Expenses: §195
   c. Syndication Costs: §709(a)

3. §709(b) defines organizational expenditures which are:

   a. Incident to the creation of the partnership;
   b. Chargeable to a capital account, and
   c. Of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

4. These costs include the following items:

   a. Legal fees incurred in drafting the partnership agreement,
   b. Filing fees for registering the partnership with state and local authorities, and
   c. Related costs.
Tax Professional Note: Any costs related to or incurred in selling interests in the partnership are defined in §709(a) as syndication costs and are specifically excluded from the definition of organizational costs.

- Syndication costs are **permanently** capitalized.
- Organization costs are **amortizable**.

5. The organizational costs must be identified in order to be capitalized and amortized.

**EXAMPLE 1**: A partnership began business in the current year and is a calendar year taxpayer, therefore the due date of its first return is **March 15**. The partnership paid a law firm **$3,500** to draft the partnership’s agreement and **$500** to register with the state offices. The partnership also paid **$10,000** to find suitable limited partner investors. In this scenario the legal and registration fees qualify as **organizational** expenditures under §709(b) while the brokerage fees are by default treated as **syndication** fees under §709(a).

6. §709(b) also provides that a partnership can **elect** to amortize organizational costs over a period of **180** months.

7. The amortization period begins with the month that the partnership **begins** business. Any unamortized amount at the time that the partnership is liquidated may be deducted in total under the loss provisions of §165.

8. **Reg. 1.709-2** states that organizational costs eligible for amortization are limited to expenditures paid or incurred during the period that **begins** with a reasonable time **before** the partnership begins business and **ends** with the original due date (NOT including extensions) of the tax return for the year in which the partnership begins business operations.

Tax Professional Note: Organizational costs incurred outside of this time period are required to be capitalized and nondeductible.

**EXAMPLE 2**: The partnership in Example 1 above pays **$1,500** for legal fees incurred in **May** of the current tax year in order to reduce an oral partnership agreement to writing. Since the costs were incurred **after** the original due date of the **March 15** tax return these costs are capitalized and **nonamortizable** and **cannot be deducted** as ordinary and necessary business expenses under §162.

Tax Professional Note: Cash basis partnerships **cannot** amortize costs that are not paid by the end of the tax year. However, in the year when the expense is actually paid, the partnership can “catch-up” for the prior year amortization deduction that would have been allowed had the expense been paid in the year incurred. [Reg. 1.709-1(b)]
EXAMPLE 3: Assume in Example 2 above that the partnership is a cash basis taxpayer and $2,000 of organizational costs incurred in the tax year were paid on February after the year was over. Since the money wasn’t paid until the next tax year there is no amortization on the $2,000 incurred in the prior year. If the partnership began business on 7/1 and elects a 180 month amortization period then the partnership can deduct maximum amortization expenses of $133 in the current year and $467 in the subsequent year as follows:

**Current Year:**
- Legal Fees: $3,500
- Filing Fees: $500
- Total Cost: $4,000
- Amortization: ($4,000 x 6/180=$133)

**Subsequent Year:**
- Total Costs ($6,000 x 12/180): $400
- Catch-Up ($2,000 x 6/180): 67
- Total: $467

**Tax Professional Note:** Reg. 1.709-1(c) states that the amortization election must be made by attaching a statement to a timely filed return (including extensions) for the year in which the partnership commences business operations. A detailed listing of each item should be reported on the statement. The amortization expense is reported on Form 4562, page 2 at the bottom of the page.

**M. Commencement of Business Operations**

1. **Reg. 1.709-2(c)** states that the acquisition of operating assets necessary to conduct the contemplated business is a primary factor in determining when the partnership begins business. Mere administrative actions such as signing a partnership agreement or registering to do business in a state do not by themselves constitute the beginning of business for this purpose. There are various court cases and IRS rulings that can be referred to.

**EXAMPLE:** A partnership entered into an oral agreement in September of 20XX and immediately began negotiations to acquire fixed assets for use in the intended business operations. The acquisition of the assets are not finalized until June 20XY. Under §709 the partnership is considered to begin business in June 20XY when the operating assets of its trade or business are acquired. As a result the organizational costs are amortizable over 180 months beginning in June 20XY.
N. Start Up Costs: §195

1. §195 provides that operating costs that are incurred after the entity is formed but before it begins business may not be deducted. These are capitalized and amortized over a period of 180 months starting in the month in which the partnership begins business.

2. When a taxpayer begins business is a facts and circumstances determination. Generally, the start-up period ends when a taxpayer is in a position to begin earning revenue, E.G.: If obtaining a local business license is a prerequisite to the legal operation of the trade or business then the taxpayer is still in a start-up period at least until the license is obtained.

3. Examples of start-up costs include: marketing surveys prior to conducting business, pre-operating advertising expenses, costs of establishing an accounting system and salaries paid before the start of the business.

EXAMPLE: After the acquisition of its business assets in June the partnership in the previous example incurred $5,000 in advertising costs and salaries before beginning the active conduct of its trade or business in August. During the same period the partnership incurred $3,000 of interest and taxes. Since the partnership was not conducting an active trade or business when the expenses were incurred, the advertising and salaries cannot be deducted as ordinary and necessary business expenses under §162. Instead they are required to be capitalized and amortized under §195. However, the $3,000 of interest and taxes incurred during the same period can be deducted on a current basis under §163 interest and §164 taxes. §195 does not apply.

4. §195 costs are elected by attaching a statement to the tax return by the due date of the first return including extensions just like §709(b) organization costs and are reported on Form 4562, page 2 at the bottom.

Tax Professional Note: Catch-up provisions are also available to cash basis partnerships that incurred §195 start-up costs in one year and paid them in a subsequent year.

O. Syndication Costs: §709(a)

1. Syndication Costs are capitalized but not amortizable. They include costs incurred for promoting and marketing partnership interests. They are generally incurred for Limited Partnerships and Publicly Traded Partnerships.
2. The costs include:
   - Brokerage Fees.
   - Registration Fees.
   - Legal fees for security advice on adequacy of tax disclosures in the prospectus or for security law purposes.
   - Accounting fees related to offer materials.
   - Printing cost of prospectus and selling materials, etc.
This course will not address these issues since they are of limited relation to the reader.

3. These capitalized costs are treated as a **loss on the disposition** of a capital asset at the time the partnership is liquidated and are passed through to the partners as **capital loss** items on Schedule K-1.

IV. Partnership Taxation Issues

A. The Entity and the Owners

1. §701 provides that a partnership is not a taxable entity. §702 provides a general rule that the taxable income or loss of the partnership flows through to the partners at the **end** of the entity’s tax year.

2. Partners report their allocable share of the partnership’s income or loss for the year on their tax returns. As a result, the partnership itself pays no federal income tax on its income; instead, the partners’ individual tax liabilities are affected by the activities of the entity.

**EXAMPLE 1:** Don is a **40%** partner in the ABC Partnership. Both Don’s and the partnership’s tax years end on December 31. In the current year, the partnership generates **$200,000** of ordinary taxable income. However, because the partnership needs capital for expansion and debt reduction, Don receives no cash distributions during the current year. Don is taxed on his **$80,000** allocable share of the partnership’s current year income, even though he received no distributions from the entity during current year. This allocated income is included in Don’s gross income reported through the **Schedule K-1** furnished by the partnership. In addition, Don’s basis in his partnership interest will increase by the **$80,000** of distributive share.
**EXAMPLE 2:** Assume the same facts as in Example 1, except the partnership recognizes a current year taxable loss of ($100,000). Don’s current year adjusted gross income is reduced by $40,000 because his proportionate share of the loss flows through to him from the partnership. He deducts a $40,000 partnership loss for the year.

**Note:** Loss limitation rules may result in some or all of this loss being deducted in a later year.

3. Many items of partnership income, deduction, gain and loss retain their identity as they flow through to the partners. This separate flow-through of certain items is required because such **separately stated items** might affect any two partners’ tax liabilities in different ways.

4. §703(a) (1) provides that when preparing a personal tax return, a partner takes each of these items into account separately. For example, charitable contributions are separately stated because partners need to compute their own personal limitation on charitable contributions. Some partners are able to deduct the entire amount they are allocated while others may be limited in the amount they can deduct based on the amount of their adjusted gross income (AGI) limitation.

**B. Partner’s Ownership Interest in a Partnership**

1. Each partner typically owns both a **capital interest** and a **profits (loss) interest** in the partnership. A capital interest is measured by a partner’s **capital sharing ratio**, which is the partner’s percentage ownership of the capital of the partnership.

2. A partner’s **capital interest** can be determined in several ways. The most widely accepted method measures the capital interest as the percentage of net asset value that a partner would receive on immediate liquidation of the partnership. (Net asset value is the remaining value after payment of all partnership liabilities.)

3. A **profits (loss) interest** is simply the partner’s percentage allocation of current partnership operating results. §704(a) provides that **profit and loss sharing ratios** are usually specified in the partnership agreement and are used to determine each partner’s allocation of partnership ordinary taxable income and separately stated items. The partnership can change its profit and loss allocations at any time simply by amending the partnership agreement.
4. Each partner’s profit, loss, and capital sharing ratios should appear on the partner’s Schedule K-1. In many cases, the three ratios are the same. A partner’s capital sharing ratio generally equals the partner’s profit and loss sharing ratios if all profit and loss allocations, for each year of the partnership’s existence, are in the same proportion as the partner’s initial contributions to the partnership.

5. The partnership agreement may, in some cases, provide for a special allocation of certain items to specified partners. Also the partnership agreement may allocate items in a different proportion from general profit and loss sharing ratios. These items are separately reported to the partner receiving the allocation.

6. §704(b) provides that in order for a special allocation to be recognized for tax purposes, it must produce nontax economic consequences to the partners receiving the allocation.

**EXAMPLE 1:** When the AU Partnership was formed, Don contributed cash and Peter contributed some municipal bonds that he had held for investment purposes. The partnership agreement allocates all of the tax-exempt interest income from the bonds to Peter as an inducement for him to remain a partner. This is an acceptable special allocation for income tax purposes because it reflects the differing economic circumstances that underlie the partners’ contributions to the capital of the entity.

Since Peter would have received the exempt income if he had not joined the partnership, he can retain the tax-favored treatment by means of the special allocation.

**EXAMPLE 2:** Assume the same facts as in Example 1. Three years after it was formed, the AU Partnership purchased some City of Falls Church bonds. The municipal bond interest income of $15,000 flows through to the partners as a separately stated item, therefore, it retains its tax-exempt status.

The partnership agreement allocates all of this income to Don because he is subject to a higher marginal income tax bracket than Peter. The partnership also allocates $15,000 more of the partnership taxable income to Peter than to Don. These allocations are not effective for income tax purposes because they have no purpose other than the reduction of the partners’ combined income tax liability.

**C. Income Increases Basis: Losses Decrease Basis**

1. A partner has a **basis in the partnership interest**. When **income** flows through to a partner from the partnership, the partner’s basis in the partnership interest **increases** accordingly. If a **loss** flows through to a partner, **then** the basis decreases.
EXAMPLE: Don contributes $20,000 cash to acquire a 30% capital and profits interest in a Partnership. In its first year of operations, the partnership earns ordinary income of $40,000 and makes no distributions to Don. Don’s initial basis is the $20,000 he paid for the interest. He reports ordinary income of $12,000 (30% x $40,000 partnership income) on his individual return and increases his basis by $12,000 to $32,000.

2. The Code provides for the increase and decrease in a partner’s basis so that the income or loss from partnership operations is taxed only once. In the above Example if Don sold his interest at the end of the first year for $32,000, then he would have no gain or loss. If the Code did not provide for an adjustment of a partner’s basis, then Don’s basis would be $20,000 and then he would be taxed again on the gain of $12,000 in addition to being taxed on his $12,000 share of income. In other words, without the basis adjustment, partnership income would be subject to double taxation.

3. A partner’s basis is important for:
   a. Determining the treatment of distributions from the partnership to the partner,
   b. Establishing the deductibility of partnership losses, and
   c. Calculating gain or loss on the partner’s disposition of the partnership interest.

4. A partner’s basis is not reflected anywhere on the Schedule K-1. Instead, each partner should maintain a personal record of adjustments to basis. Schedule K-1 does reconcile a partner’s capital account, but the ending capital account balance may not necessarily be the same amount as the partner’s basis.

5. Just as the tax and accounting bases of a specific asset may differ, a partner’s capital account and basis in partnership interest may not be equal for a variety of reasons. For example, a partner’s basis also includes the partner’s share of partnership liabilities. These liabilities are not reported as part of the partner’s capital account but are included in Question F at the top of the partner’s Schedule K-1.

D. Conceptual Basis for Partnership Taxation

1. The unique tax treatment of partners and partnerships can be traced to two legal concepts that evolved long ago: the aggregate (or conduit) concept and the entity concept. These concepts influence practically every partnership tax rule.
• **Aggregate (or Conduit) Concept**: The aggregate (or conduit) concept treats the partnership as a channel through which income, credits, deductions, and other items flow to the partners. Under this concept, the partnership is regarded as a collection of taxpayers joined in an agency relationship with one another. The imposition of the income tax on individual partners reflects the influence of this doctrine.

• **Entity Concept**: The entity concept treats partners and partnerships as separate units and gives the partnership its own tax “personality” by:

  (1) Requiring a partnership to file an information tax return and

  (2) Treating partners as separate and distinct from the partnership in certain transactions between a partner and the entity.

**Tax Professional Note**: A partner’s recognition of capital gain or loss on the sale of the partnership interest illustrates this doctrine.

• **Combined Concepts**: Some rules such as the various provisions governing the formation, operation, and liquidation of a partnership contain a blend of both the entity and aggregate concepts.

E. **Anti-Abuse Provisions**

1. Partnership taxation is often flexible. For example, partnership operating income or losses can sometimes be shifted among partners, and partnership property gains and losses can sometimes be shifted from one partner to another.

2. The Code contains many provisions designed to thwart unwarranted allocations, but the IRS believes opportunities still abound for tax avoidance. The IRS has adopted Regulations that allow it to recharacterize transactions that it considers to be “abusive.” [Reg. §1.701-2](https://www.irs.gov/). 

F. **Transactions between Partner and Partnership: §707**

1. **§707(a)(1)** provides a general rule that if a partner engages in a transaction with a partnership other than in the capacity as a member of such partnership then the transaction shall be considered as occurring between the partnership and one who is not a partner.

2. **§707(a) (2) (A)** addresses the treatment of payments for services and transfers of property between a partner and a partnership. The law states that if:

   a. A partner performs services or transfers property;
b. There is a related direct or indirect allocation and distribution to such partner; and

c. The performance of such service or transfer of property and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a third party then such transaction will be treated and respected as such.

3. §707(a)(2)(B) provides that if there is a transfer of property between partners in a capacity other than as partner of the partnership the transaction will be respected and treated as between third parties.

4. §707(c) addresses the issue of guaranteed payments which provides that payments to a partner for services or use of capital shall be considered as made to a third party therefore causing the inclusion of income for the partner under §61(a) and a deduction to the partnership as a trade or business expense under §162(a) and capital expenditures under §263.

5. Guaranteed payments may not be determined based on partnership income. A guaranteed payment is expressed as a fixed dollar amount or percentage of capital that the partner has invested in the partnership.

EXAMPLE 1: Don, Peter and Paul form a partnership. According to the partnership agreement the following will take place.

- Don will manage and receive a $24,000 every year payable $2,000 per month on the last day of the month.

- Peter will receive 18% of his capital balance as computed by the firm accountant at the beginning of the year, payable in 12 monthly installments.

- Paul is providing advertising expertise and receives 3% a month of the partnership’s net income.

RESULT: Don and Peter receive guaranteed payments and therefore have a definite gross income inclusion for the amounts received while the partnership receives a deduction. Paul’s withdraw is based on the net income each month, therefore since a net income is never a definite item the distribution is a special allocation item under §704(b) and a distribution under §731. The partnership does not have a deductible item on the Form 1065.

6. A guaranteed payment is always taxable as ordinary income and subjected to self-employment tax. The partner treats the payment as if it was received on the last day of the partnership year.
EXAMPLE 2: As a follow-up to Example 1 above assume that Don got his $24,000 and Peter’s payment for his capital was $14,000. Paul had monthly draws during the year equal to $20,000. The partnership ordinary income before the guaranteed payments was $650,000.

Ordinary Income Before Guaranteed Payments $650,000
Less: Guarantee to Don (24,000)
       Guarantee to Peter (14,000)
Total Distributive Share $612,000

Since each partner has a 1/3 interest they each will have a distributive share of $204,000.

Paul receives a distributive share of $204,000 with a corresponding increase to basis and a distribution of $20,000 for the monthly draws for a resulting net increase in basis of $184,000. The other two partners had a net increase in basis of $204,000.

Tax Professional Note: The guaranteed payment is not accounted for as an increase and decrease in basis because a deduction is taken by the partnership and it is treated as a transaction dealing with a third party.

V. Formation of a Partnership: Tax Effects

A. Gain or Loss on Contributions to the Partnership: §721

1. Under the general rules of exchange §1001(c) provides that when a taxpayer transfers property to an entity in exchange for valuable consideration, a taxable exchange normally results. Typically, both the taxpayer and the entity realize and recognize gain or loss on the exchange.

2. §1001(a) states that the gain or loss recognized by the transferor is the difference between the fair market value of the consideration received and the adjusted basis of the property transferred.

3. However, in most situation §721 provides that neither the partner nor the partnership recognizes the gain or loss that is realized when a partner contributes property to a partnership in exchange for a partnership interest. Instead, the realized gain or loss is deferred.

4. There are two reasons for this nonrecognition treatment.

   a. First, forming a partnership allows investors to combine their assets toward greater economic goals than could be achieved separately. Only the form of ownership, rather than the amount owned by each investor, has changed.
Requiring that gain be recognized on such transfers would make the formation of some partnerships economically unfeasible (e.g., two existing proprietorships are combined to form one larger business). Congress does not want to hinder the creation of valid economic partnerships by requiring gain recognition when a partnership is created.

b. **Second**, because the partnership interest received is typically not a liquid asset, the partner may not have sufficient cash to pay the tax. Thus, deferral of the gain recognizes the economic realities of the business world and follows the wherewithal to pay principle of taxation.

**EXAMPLE 1**: Don transfers two assets to a Partnership on the day the entity is created, in exchange for a 60% profit and loss interest worth $60,000. He contributes cash of $40,000 and retail display equipment with a **FMV of $20,000**. The **adjusted basis** to him as a sole proprietor was $8,000. Since an exchange has occurred between two parties, Don **realizes** a $12,000 gain on this transaction. The gain **realized** is the fair market value of the partnership interest of $60,000 less the $48,000 basis of the assets that Don surrendered to the partnership [$40,000 (cash) + $8,000 (equipment)].

Under §721, Don does not **recognize** the $12,000 realized gain in the year of contribution since all he received from the partnership was an illiquid partnership interest. He received no cash with which to pay any resulting tax liability.

**EXAMPLE 2**: Assume the same facts as in Example 1, **except** that the equipment Don contributes to the partnership has an **adjusted basis** of $25,000. He has a **$5,000 realized** loss [$60,000 - ($40,000 + $25,000)], but he cannot deduct the loss. Realized losses, as well as realized gains, are deferred by §721.

Unless it was essential that the partnership receive Don’s display equipment rather than similar equipment purchased from an outside supplier, Don should have considered selling the equipment to a third party. This would have allowed him to deduct a $5,000 loss in the year of the sale. Don then could have contributed $60,000 cash (including the proceeds from the sale) for his interest in the partnership, and the partnership would have funds to purchase similar equipment.

**EXAMPLE 3**: Five years after the Partnership (Examples 1 and 2) was created Don contributes another piece of equipment to the entity. This property has a basis of **$35,000** and a fair market value of **$50,000**. Don will **defer** the recognition of the $15,000 realized gain. §721 is effective at any time that a partner makes a contribution to the capital of the partnership not just at the time of formation of the entity.
Note: This is different than a §351 corporate transaction where gain is deferred only on the assets transferred on the formation that meets an “80% control test.”

5. If a partner contributes only capital and §1231 assets, then the partner’s holding period in the partnership interest is the same as that partner’s holding period for these assets.

6. If cash or other assets that are not capital or §1231 assets are contributed, then the holding period in the partnership interest begins on the date the partnership interest is acquired.

7. If multiple assets are contributed, then the partnership interest is apportioned, and a separate holding period applies to each portion.

B. Exceptions to §721

1. The nonrecognition provisions of §721 do not apply where:
   - Appreciated stocks are contributed to an investment partnership;
   - The transaction is essentially a taxable exchange of properties;
   - The transaction is a disguised sale of properties; or
   - The partnership interest is received in exchange for services rendered to the partnership by the partner.

C. Investment Partnership

1. §721(b) provides that if the transfer consists of appreciated stocks and securities and the partnership is an investment partnership, then it is possible that the realized gain on the stocks and securities will be recognized by the contributing partner at the time of contribution.

2. This provision prevents multiple investors from using the partnership form to diversify their investment portfolios on a tax-free basis.

D. Exchange

1. The regulations state that if a transaction is essentially a taxable exchange of properties, then the tax is not deferred under the nonrecognition provisions of §721. Reg. §1.731-1(c) (3).
EXAMPLE: Sara owns land, and Bob owns stock. Sara would like to have Bob’s stock, and Bob wants Sara’s land. If Sara and Bob both contribute their property to newly formed SB Partnership in exchange for interests in the partnership, then the tax on the transaction appears to be deferred under §721.

Under the general provisions of §731, the tax on a subsequent distribution by the partnership of the land to Bob and the stock to Sara also appears to be deferred. According to a literal interpretation of the statutes, no taxable exchange has occurred. Sara and Bob will find, however, that this type of tax subterfuge is not permitted. The IRS will disregard the passage of the properties through the partnership and will hold, instead, that Sara and Bob exchanged the land and stock directly. Thus, the transactions will be treated as any other taxable exchange under §1001.

E. Disguised Sale

1. A similar result occurs in a disguised sale of properties. A disguised sale may occur when a partner contributes appreciated property to a partnership and soon thereafter receives a distribution from the partnership.

2. §707(a) (2) (B) provides that this distribution may be viewed as a payment by the partnership for purchase of the property.

EXAMPLE: Don transfers property to the AU Partnership. The property has an adjusted basis of $10,000 and a fair market value of $30,000. Two weeks later, the partnership makes a distribution of $30,000 cash to Don.

Under the distribution rules of §731, the distribution would not be taxable to Don if the basis for his partnership interest prior to the distribution was greater than the $30,000 cash distributed. However, the transaction appears to be a disguised purchase-sale transaction, rather than a contribution and distribution. Therefore, Don must recognize gain of $20,000 on transfer of the property, and the partnership is deemed to have purchased the property for $30,000.

3. Extensive Regulations under §707 outline situations in which the IRS will presume a disguised sale has occurred. For example, a disguised sale is presumed to exist if both the following occur:

a. A contractual agreement requires a contribution by one partner to be followed within two years by a specified distribution from the partnership, and

b. The distribution is to be made without regard to partnership profits. In other words, the forthcoming distribution is not subject to significant “entrepreneurial risk.”
4. In some cases, the assumption of a partner’s liabilities by the partnership may be treated as part of the purchase price paid by the partnership. The IRS can also use a facts and circumstances test to treat a transaction as a disguised sale.

5. The Regulations also outline situations in which a distribution generally will not be deemed to be part of a disguised sale. They include a distribution that occurs more than two years after the property is contributed and a distribution that is deemed “reasonable” in relation to the capital invested by the partner and in relation to distributions made to other partners.

F. Services

1. A final exception to the nonrecognition provisions of §721 occurs when a partner receives an interest in the partnership as compensation for services rendered to the partnership. This is not a tax-deferred transaction because services are not treated as “property” that can be transferred to a partnership on a tax-free basis.

2. Instead, §83(a) provides that the partner performing the services recognizes ordinary compensation income equal to the fair market value of the partnership interest received.

3. The partnership may deduct the amount included in the service partner’s income if the services are of a deductible nature. If the services are not deductible to the partnership, then they must be capitalized to an asset account.

   For example, architectural plans created by a partner are capitalized as part of the structure built with those plans. Alternatively, day-to-day management services performed by a partner for the partnership are usually deductible by the partnership.

   EXAMPLE: Don, Carl, and Peter form a Partnership, with each receiving a one-third interest in the entity. Peter receives his one-third interest as compensation for tax planning services he rendered during the formation of the partnership. The value of a one-third interest in the partnership (for each of the parties) is $20,000. Peter recognizes $20,000 of compensation income, and he has a $20,000 basis in his partnership interest. The same result would occur if the partnership had paid Peter $20,000 for his services and he immediately contributed that amount to the entity for a one-third ownership interest. In either case, the partnership deducts $20,000 in calculating its net ordinary business income.

G. Tax Issues Relative to Contributed Property: §723

1. §723 provides that when a partner makes a tax-deferred contribution of an asset to the capital of a partnership, the tax law assigns a carryover basis to the property.

2. The partnership’s basis in the asset is equal to the partner’s basis in the property prior to its transfer to the partnership.
3. The **partner**’s basis in the new **partnership interest** is the same as the partner’s basis in the contributed asset. The tax term for this basis concept is **“substituted basis.”**

4. Thus, two assets are created out of one when a partnership is formed, namely, the property in the hands of the new entity and the new asset (the partnership interest) in the hands of the partner. Both assets are assigned a basis that is derived from the partner’s basis in the contributed property.

5. In order to understand the logic of these rules, consider what Congress was attempting to accomplish with the deferral approach. Recall that gain or loss is deferred when property is contributed to a partnership in exchange for a partnership interest. The basis amounts are the amounts necessary to allow for recognition of the deferred gain or loss if the property or the partnership interest is subsequently disposed of in a taxable transaction.

**Tax Professional Note:** This treatment is similar to the treatment of assets transferred in a §351 transfer to a controlled corporation and the treatment provided under §1031 for like-kind exchanges.

**EXAMPLE:** On June 1 of the current tax year, Don transfers property to the AU Partnership in exchange for a one-third interest in the partnership. The property has an adjusted basis to Don of **$10,000** and a fair market value of **$30,000**. Don has a **$20,000** realized gain on the exchange ($30,000 - $10,000), but under §721, he does **not** recognize any of the gain.

Don’s basis for his **partnership interest** is the amount necessary to recognize the **$20,000** deferred gain if his partnership interest is subsequently sold for its **$30,000** fair market value. This amount is **$10,000** and is referred to as the **“substituted basis.”** The basis of the property contributed to the partnership is the amount necessary to allow for the recognition of the **$20,000** deferred gain if the property is subsequently sold by the partnership for its **$30,000** fair market value. This amount is also **$10,000** and is referred to as **carryover basis.**

**Tax Professional Note:** The **holding period** for the contributed asset **carries over** to the partnership. Thus, the **partnership’s** holding period for the asset includes the period during which the **partner** owned the asset.

**H. Depreciation Method and Period**

1. If depreciable property is contributed to the partnership, then the partnership is usually required to use the same cost recovery method and life used by the partner. The partnership merely “steps into the shoes” of the partner and continues the same cost recovery calculations.

2. The partnership may not immediately expense any part of the basis of depreciable property it receives from the transferor partner by electing §179 treatment.
I. Receivables, Inventory and Losses

1. In order to prevent ordinary income from being converted into capital gain, gain or loss is treated as ordinary when the partnership disposes of either of the following:

   - **Contributed receivables** that were **unrealized** in the contributing partner’s hands at the contribution date. Such receivables include the right to receive payment for goods or services delivered or to be delivered.

   - **Contributed property** that was **inventory** in the contributor’s hands on the contribution date, if the partnership disposes of the property **within five years** of the contribution. For this purpose, inventory includes all tangible property except capital assets and real or depreciable business assets.

**EXAMPLE 1**: Don operates a cash basis retail electronics and television store as a sole proprietor. Peter is an enterprising individual who likes to invest in small businesses. On January 2 of the current year, Don and Peter form a partnership. Their partnership contributions are as follows:

<table>
<thead>
<tr>
<th>Adjusted Fair Market</th>
<th>Difference</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>From: Don</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>$ -0-</td>
<td>$ 2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Land used as parking lot*</td>
<td>1,200</td>
<td>5,000</td>
<td>3,800</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,500</td>
<td>5,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Subtotals</td>
<td>3,700</td>
<td>12,000</td>
<td>8,300</td>
</tr>
<tr>
<td>From Peter:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>12,000</td>
<td>12,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Totals</td>
<td>$15,700</td>
<td>$24,000</td>
<td>$8,300</td>
</tr>
</tbody>
</table>

*The parking lot had been held for nine months at the contribution date.

Within 30 days of formation, the partnership collects the receivables for the $2,000 FMV and sells the inventory for $5,000 cash. It uses the land for the next 10 months as a parking lot, then sells it for $3,500 cash. The partnership realizes the following income in the current year from these transactions:

- Ordinary income of $2,000 from collecting receivables.
- Ordinary income of $2,500 from sale of inventory.
- §1231 gain of $2,300 from sale of land.
Since the land takes a carryover holding period, it is treated as having been held 19 months at the date of sale.

2. A similar rule is designed to prevent a capital loss from being converted into an ordinary loss. Under this rule, if contributed property is disposed of at a loss and the property had a “built-in” capital loss on the contribution date, then the loss is treated as a capital loss if the partnership disposes of the property within five years of the contribution. The capital loss is limited to the amount of the “built-in” loss on the date of contribution.

**EXAMPLE 2:** Assume the same facts as in Example 1 above except:

- Don held the land for investment purposes. It had a fair market value of $800 at the contribution date.
- The partnership used the land as a parking lot for 10 months and sold it for $650.

The partnership realizes the following income and loss from these transactions:

- Ordinary income of $2,000 from collecting receivables.
- Ordinary income of $2,500 from sale of inventory.
- Capital loss of $400 from sale of land ($1,200 - $800).
- §1231 loss of $150 from sale of land ($800 - $650).

Since the land was sold within five years of the contribution date, the $400 built-in loss is a capital loss. The post-contribution loss of $150 is a §1231 loss since the partnership used the property in its business.

### J. Inside and Outside Bases

1. Throughout the course, reference is made to the partnerships inside basis and the partners’ outside basis.

2. **Inside basis** refers to the adjusted basis of each partnership asset, as determined from the partnership’s tax accounts.

3. **Outside basis** represents each partner’s basis in the partnership interest.

4. **Each partner** “owns” a share of the partnership’s inside basis for all its assets and **should maintain** a record of the partner’s outside basis.

5. In many cases, especially on formation of the partnership, the total of all the partners’ outside bases equals the partnerships inside bases for all its assets.
Differences between inside and outside basis arise when a partner’s interest is sold to another person for more or less than the selling partner’s share of the inside basis of partnership assets.

6. The buying partner’s outside basis equals the price paid for the interest, but the buyer’s share of the partnership’s inside basis is the same amount as the seller’s share of the inside basis.

K. Tax Accounting Elections: §703

1. A newly formed partnership must make numerous tax accounting elections. These elections are formal decisions on how a particular transaction or tax attribute should be handled.

2. §703(b) provides that most of these elections must be made by the partnership rather than by the partners individually. The partnership makes the elections involving the following items:
   - Inventory method.
   - Cost or percentage depletion method, excluding oil and gas wells.
   - Accounting method (cash, accrual or hybrid).
   - Cost recovery methods and assumptions.
   - Tax year.
   - §248 Amortization of organizational costs and amortization period.
   - §195 Amortization of start-up expenditures and amortization period.
   - §754 Optional basis adjustments for property.
   - §179 deductions for certain tangible personal property.
   - §1033 Nonrecognition treatment for involuntary conversions gains.

3. Each partner is bound by the decisions made by the partnership relative to the elections. If the partnership fails to make an election, then a partner cannot compensate for the error by making the election individually.

4. Though most elections are made by the partnership, each partner individually is required to make a specific election on the following relatively narrow tax issues:
   - §108(b) (5) or §108(c) (3): Whether or not to reduce the basis of depreciable property first when excluding income from discharge of indebtedness under §108.
• §617: Whether to claim cost of percentage depletion for oil and gas wells.

• §901: Whether to take a deduction or a credit for taxes paid to foreign countries and U.S. possessions.

L. Timing and Valuation of Property Contributions

1. When there is an owner contribution of property to a partnership the timing generally is not an issue because generally there will be a legal transfer of title which solidifies the date that the transaction takes place. The date should be recorded in the operating agreement or a separate contribution agreement among parties involved.

2. Valuation of contributed property can sometimes be a challenge. It is important to determine in order to have the proper ownership interest percentage desired among the partners that can be defended in order to ward off any challenge by the IRS. The partners should specify a reasonable method that they have agreed to for valuing each asset contributed.

• The Code does not require that a professional appraisal be performed but it certainly is a more defensible position for a client. The tax professional should always recommend the professional appraisal.

M. Documentation of Contribution

1. Documentation of capital contributions is important. Most state statutes enforce only written contribution obligations. Accordingly, the terms of each capital contribution should be in writing, signed by both the partnership and the partner/contributor and should include the following:

   a. Name, address, and employer identification number of the partner and the partnership.

   b. Description of the property, services, etc. to be contributed.

   c. The property’s value and the method used to determine the value.

   d. The date the contribution is deemed to be made.

   e. The percentage interest in the partnership received for the contribution.

   f. Any liabilities assumed in connection with the contribution.

   g. Any other conditions or terms agreed to by the parties.

   h. Written transfer document, where appropriate (for example, an assignment of title).
2. Copies of the contribution agreements should be maintained as part of the partnership’s permanent records and should be given to each partner.

N. Summary Concept: Partnership Formation and Basis Computation

1. The **entity concept** treats partners and partnerships as **separate** units. The nature and amount of entity gains and losses and most partnership tax elections are determined at the **partnership level**.

2. The **aggregate concept** is used to **connect** partners and partnerships. It allows income, gains, losses, credits, deductions, etc., to flow through to the **partner level** for separate tax reporting.

3. Under the **combined concept** sometimes both the aggregate and the entity concepts apply to the same transaction.

4. **Generally**, partners or partnerships do not **recognize** gain or loss when property is contributed for capital interests.

5. Partners **contributing property** for partnership interests take the contributed property’s **adjusted basis** for their outside basis in their partnership interest. The partners therefore have a **substituted basis** in their partnership interest.

6. The **partnership** will continue to use the contributing partner’s **adjusted basis** for the inside basis in property it receives. The contributed property is said to take a **carryover basis** from the partner.

7. The **holding period** of a partner’s partnership interest includes the holding period of the contributed property when the property was a **§1231** asset or capital asset in the hands of the partner, therefore providing a **carryover holding period**. Otherwise, the holding period starts **on the day** the interest is acquired. The **holding period** of an interest acquired by a cash contribution **starts at acquisition**.

8. The **partnership’s holding period** for contributed property includes the contributing partner’s **holding period**.

O. Basis of a Partnership Interest

1. A partner’s adjusted **basis** in a newly formed partnership usually **equals**:
   
   a. Adjusted basis in contributed **property, plus**
   b. Fair market value of **services** performed for an equity interest in the partnership.
2. A partnership interest can also be acquired after the partnership has been formed.

3. The **method of acquisition** will control how the initial basis is calculated. **If** the partnership interest is:

   a. **Purchased** from an existing partner **then** it is a **cost** basis.
   
   b. Acquired by **gift** from an existing partner **then** it is a **carryover** basis plus possible gift taxes paid on the transfer of the gift.
   
   c. Acquired by an **inheritance** **then** it is the **FMV** of the interest on the date of the decedent partner’s death.

4. After a partner acquires the interest in the partnership, the partner’s basis is **adjusted** for items which will both increase and decrease the basis on an **annual** schedule.

5. The following **annual** operating **results** will **increase** the partner’s **basis**:

   a. **Distributive** share of partnership **income**.
   
   b. **Proportional** share of increase in partnership **liabilities**.
   
   c. Additional **contributions** of capital.

6. The following **annual** operating results will **decrease** the partner’s adjusted basis in the partnership **interest**:

   a. **Distributive** share of **losses**.
   
   b. **Distributive** share of **nondeductible expenses**.
   
   c. **Proportionate** share of decrease in partnership **liabilities**.
   
   d. **Distributions** from partnership **to** the **partner**.

7. It is important to note that a partner’s adjusted basis is also **increased by tax exempt income**. Also important is that in **no** circumstances can a partner have a basis reduced **below zero**.
8. The following formula calculates a partner’s \textit{initial adjusted basis} in their partnership interest:

\textbf{Initial Basis:}

\begin{itemize}
  \item Money
  \item \textbf{Carryover Basis of Property} Transferred to Partnership
  \item \textbf{Services} Contributed \textit{@ FMV}
  \item Donors Basis if \textbf{Gift} (and possible gift tax)
  \item FMV on Decedent’s Death if \textbf{Inherited}
  \item \textbf{Partner Debt} Assumed by Partnership
  \item Partner’s Share of \textbf{Partnership Debt} Assumed
\end{itemize}

\begin{equation*}
\text{Initial Basis} = \text{Initial Adjusted Basis in Partnership Interest}
\end{equation*}

9. The following formula calculates a partner’s annual adjustments to basis:

\textbf{Initial Basis:}

\begin{itemize}
  \item Distributive Share of \textbf{Current Year Income}
  \item Proportional Share of \textbf{Increase} in Partnership \textit{Liabilities}
  \item \textbf{Additional Capitalization} by the Partner
  \item Distributive Share of \textbf{Current Year Loss} and Deductions
  \item Distributive Share of \textbf{Nondeductible} Costs
  \item \textbf{Distributions} to the Partner
  \item Proportional Share of \textbf{Decrease} in Partnership \textit{Liabilities}
\end{itemize}

\begin{equation*}
\text{Initial Basis} = \text{Partner’s Ending Basis in Partnership Interest @ Year End}
\end{equation*}

\textbf{P. Basis Ordering Rules}

\textit{Basis is generally adjusted in the following order:}

\textbf{Initial Basis.}

\textbf{Plus:} Partner’s subsequent contributions

\textbf{Plus:} Partner’s share of the partnership distributive share of:

- Debt increase
- Taxable income items
- Exempt income items
- Excess of depletion deductions over adjusted basis of property subject to depletion
Less:

- Partner’s distributions and withdrawals
- Debt decrease
- Nondeductible items not chargeable to a capital account
- Special depletion deduction for oil and gas wells
- Loss Items

= The basis of a partner’s interest

VI. Income Tax Advantages

A. §721 Formation

1. §721(a) of the Internal Revenue Code provides a general rule that no gain or loss shall be recognized by the partnership or by any of the partners on the contribution of property to the partnership in exchange for an interest in the partnership.

2. §722 of the Code provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution.

In other words the partner's basis in the partnership interest is a carryover of the adjusted basis in the assets given up.

3. §723 of the Code provides that the basis of the property contributed to the partnership by a partner shall be the adjusted basis of such property in the hands of the contributing partner at the time of the contribution by the partner.

4. The regulations provide however that there is a gain recognized by a partner who transfers services to a partnership in exchange for a partnership interest. (Reg. §1.721-1(b) (1)).

5. There is also an exception to the nonrecognition of gain on the transfer of property when a partner transfers property to a partnership subject to a liability at the time of contribution.

6. All partners are allocated a part of the liability based on their partnership interest therefore the liability allocated to the other partners is treated as a cash distribution to the contributing partner by the partnership.

7. This distribution reduces the contributing partner's basis in his partnership interest dollar for dollar, but the other partners' bases are increased by the amount of the liability allocated to them.
8. Although the contribution of an asset does not, by itself, cause gain to be recognized, there is an exception if the amount of the liability allocated to the non-contributing partners exceeds the contributing partner’s basis in the partnership. If this is the result then the excess is taxable as capital gain to the contributing partner.

EXAMPLE: §721 Partnership Formation

Don and Peter form a general partnership with each having a 50/50 ownership interest. Don contributes $10,000 in cash and his personal single family home with an adjusted basis of $95,000. The FMV on the date of transfer is $115,000. Peter contributes his personal condo that has an adjusted basis of $75,000 and a FMV of $125,000.

Under the provision of §721 neither partner recognizes gain or loss on the contribution of property in exchange for their partnership interest. Also, the newly formed partnership does not recognize any gain or loss on the receipt of property.

§722 provides that the partners’ basis in their partnership interest received is a carryover in the basis of the assets contributed to the partnership. Therefore, Don’s basis in the partnership interest is $105,000 (cash $10,000 + real estate of $95,000). Peter’s basis in his partnership interest is $75,000, the same basis that he had in the condo.

§723 provides that the partnership’s adjusted basis in the contributed assets is the same as each partner’s basis in each of the assets prior to the contribution to the partnership.

Under §722 each of the partners now has a new asset called “partnership interest” that they exchanged for old assets of cash and real estate.

<table>
<thead>
<tr>
<th></th>
<th>Tax Basis Prior to Formation</th>
<th>Tax Basis After Formation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Don: Cash</td>
<td>$10,000</td>
<td>$105,000</td>
</tr>
<tr>
<td>House</td>
<td>95,000</td>
<td>105,000</td>
</tr>
<tr>
<td>Partnership Interest</td>
<td>-0-</td>
<td>105,000</td>
</tr>
<tr>
<td>Total Adjusted Basis</td>
<td>$105,000</td>
<td>$105,000</td>
</tr>
<tr>
<td>Peter: Condo</td>
<td>$75,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Partnership Interest</td>
<td>-0-</td>
<td>75,000</td>
</tr>
<tr>
<td>Total Adjusted Basis</td>
<td>75,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Total Basis</td>
<td>$180,000</td>
<td>$180,000</td>
</tr>
</tbody>
</table>
The partnership’s accounting entry to record the transaction reporting the §721 formation of the partnership and receipt of assets is as follows:

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>House</td>
<td>95,000</td>
</tr>
<tr>
<td>Condo</td>
<td>75,000</td>
</tr>
<tr>
<td>Capital – Don</td>
<td>105,000</td>
</tr>
<tr>
<td>Capital – Peter</td>
<td>75,000</td>
</tr>
</tbody>
</table>

Remember each owner has a 50/50 ownership percentage because each contributed property with a FMV of $125,000.

<table>
<thead>
<tr>
<th></th>
<th>Don</th>
<th>Peter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 10,000</td>
<td>-0-</td>
</tr>
<tr>
<td>House</td>
<td>115,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Condo</td>
<td>-0-</td>
<td>125,000</td>
</tr>
<tr>
<td>Total FMV</td>
<td>$125,000</td>
<td>$125,000</td>
</tr>
</tbody>
</table>

B. Non-Taxable Entity

1. Since the partnership is a pass-through entity, all items of income, deduction, loss and credit pass through from the entity to the partners and are allocated in accordance with the partnership agreement.

2. Any item that passes through from the entity retains its tax character in the hands of the partner.

3. A partner's share of these pass-through items is called the partner's distributive share, even though these items may not actually be distributed.

C. Special Allocations of Distributive Share Allowed: §704

1. §704(a) provides a general rule that a partner's distributive share of income, gain, loss, deduction or credit shall be determined by the partnership agreement.

2. §704(b) provides that a partner's distributive share of income, gain, loss, deduction or credit shall be determined in accordance with the partner's ownership interest in the partnership if:

   a. The partnership agreement does not provide as to the partner's share of income, gain, loss, deduction, or credit

OR
b. The allocation to a partner under the terms of the §704(a) agreement of income, gain, loss, deduction or credit does not have “substantial economic effect.”

D. Partnership Debt Allows Creation of Partner Basis: §752

1. One of the great advantages that a partnership has over a corporation is that the debt entered into by the partnership creates basis for each of the partners to the extent of their partnership interest.

2. §752(a) provides that any increase in a partner’s share of the liabilities of a partnership or any increase in a partner’s individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered a contribution of money by such partner to the partnership.

3. There is an offsetting effect however. The reduction of partnership liabilities decreases the partner's basis to the extent of the partner's ownership interest in the partnership.

4. Specifically §752(b) states that any decrease in a partner’s share of the liabilities of a partnership or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

E. Allocation of Partnership Debt among Partners: §752

1. §752 provides that a partner’s adjusted basis will be increased and decreased for changes in partnership debt.

2. Partnership debt includes any obligation of the partnership which:

   a. Creates an asset,
   b. Results in a deductible expense, or
   c. Results in a nondeductible, non-capitalizable item.

3. As stated throughout this outline §752(a) provides that an increase in a partner’s share of partnership debt is deemed as a contribution of cash by the partner to the partnership.

4. §752(b) states that a decrease in partnership debt is a deemed distribution of cash from the partnership to the partner.
5. An individual partner’s share of partnership debt decreases as the result of:
   a. Decreases in the total amount of partnership debt, and
   b. Assumption of a partner’s debt by the partnership.

**EXAMPLE 1:** Don and Peter contribute property to the AU partnership. Don contributes cash of $30,000. Peter contributes land with an adjusted basis and FMV of $45,000. There is a $15,000 mortgage on the property. AU borrows $150,000 to construct a building on the land.

At the end of the year AU, an accrual basis partnership, owes $3,500 in accounts payable. There are no other transactions. For purposes of illustration Don and Peter share liabilities equally. The following calculation determines each partner’s basis in their partnership interest as follows:

<table>
<thead>
<tr>
<th></th>
<th>Don</th>
<th>Peter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contributed Cash</td>
<td>$30,000</td>
<td>-0</td>
<td>$30,000</td>
</tr>
<tr>
<td>Contributed Basis in Land</td>
<td>-0</td>
<td>45,000</td>
<td>45,000</td>
</tr>
<tr>
<td>Less: Debt Assumed by AU</td>
<td>-0</td>
<td>(15,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Add: Share of Debt of Each Partner</td>
<td>7,500</td>
<td>7,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Share of Construction Loan</td>
<td>75,000</td>
<td>75,000</td>
<td>150,000</td>
</tr>
<tr>
<td>Share of Accounts Payable</td>
<td>1,750</td>
<td>1,750</td>
<td>3,500</td>
</tr>
<tr>
<td>Totals Before Operations</td>
<td>$114,250</td>
<td>$114,250</td>
<td>$228,500</td>
</tr>
</tbody>
</table>

In this scenario, each partner has an equal basis in their partnership interest because each is a 50% owner and they both contributed identical net bases property.

Since §752(b) provides that decreases in a partner’s share of partnership liabilities is treated as a cash distribution, any decrease greater than basis can cause a taxable event to a partner.

**EXAMPLE 2:** Assume the same factors in Example 1 above except that AU reports an ordinary loss of ($100,000) in Year 1 and pays back all of the debt in Year 2. (Assume from collection of accounts receivable reported as revenue in Year 1.) The basis calculations will be illustrated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Don</th>
<th>Peter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Basis Before Year 1 Operations</td>
<td>$114,250</td>
<td>$114,250</td>
<td>$228,500</td>
</tr>
<tr>
<td>Net Loss in Year 1</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Basis Available End of Year 1</td>
<td>64,250</td>
<td>64,250</td>
<td>128,500</td>
</tr>
<tr>
<td>Year 2 Debt Payoff</td>
<td>(75,000)</td>
<td>(75,000)</td>
<td>(150,000)</td>
</tr>
<tr>
<td>Basis Available</td>
<td>($10,750)</td>
<td>($10,750)</td>
<td>($21,500)</td>
</tr>
</tbody>
</table>
Tax Professional Note: It is important to remember that the law states that a partner’s partnership basis cannot decrease below zero. In this example the decrease in the partnership debt is a “deemed distribution” of cash of $75,000 which is greater than the basis of $64,250 causing a capital gain to each partner which will be required to be reported on the Schedule D of their Form 1040.

- The partners include the $10,750 in gross income even though the partnership had no income. This “gain” is really a recapture of the loss deduction that each partner claimed as the result of the first year’s loss that was passed through on the Schedule K-1.

- Remember that the partnership is not responsible for reporting basis transactions on the Schedule K-1 of the partners.

VII. Contributions and Distributions of Property

A. Partnership’s Basis in Contributed Property and Contributing Partner’s Basis of Partnership Interest: §722 and §723

1. §723 provides a general rule that a partnership’s basis in contributed property is the contributing partner’s adjusted tax basis in the property.

2. If the contributing partner recognizes gain because of excess liabilities then the partnership may be entitled to a basis step-up, if a §754 election is made by the partnership.

3. §722 provides the general rule that the partner’s basis of a partnership interest is the adjusted basis in the property given up.

EXAMPLE 1: Don acquires a 1/3 interest in a partnership with the contribution of land that is not subjected to any liabilities. Don’s basis in the land is $100,000 and the FMV is $400,000. Because of the substituted basis rules of §722, Don’s basis in his partnership interest is $100,000. Don’s Schedule K-1 will reflect $100,000 of contributed capital in column (b) in the capital reconciliation account.

B. Tax Effect of Liabilities on Contributing Partner: §752

1. If property subject to liabilities is contributed and the partnership assumes the liabilities then the basis of the contributing partner’s interest is reduced by the debt assumed by the partnership.
2. The **partnership**’s assumption is treated as a cash **distribution** to the partner. In addition, the **partner**’s share of the assumed debt is treated as a **contribution** to the extent of the partnership interest.

**EXAMPLE 2:** Same details as in Example 1 in A. above except there is a mortgage of **$84,000** on the property. Don’s 1/3 interest would be reflected as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Basis of Property Contributed</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Mortgage Relief</td>
<td>$(84,000)</td>
</tr>
<tr>
<td>Equals: Subtotal in Capital Account</td>
<td>$ 16,000</td>
</tr>
<tr>
<td>Plus: Don’s 1/3 Share of Debt</td>
<td>28,000</td>
</tr>
<tr>
<td>Equals: <strong>Tax Basis in Partnership Interest</strong></td>
<td><strong>$ 44,000</strong></td>
</tr>
</tbody>
</table>

Don’s **Schedule K-1** capital account reconciliation records only **$16,000** in column (b) and “Other” Debt in Question F reports **$28,000**.

**C. Distributions By a Partnership: §731**

1. **§731(a)** provides that if a partner receives a distribution from a partnership then **no gain** is recognized **unless** the distribution is in the form of money and the amount of **money exceeds the partner's basis** in the partnership interest.

   a. A partner's basis in the partnership interest is **decreased by distribution** of money or property.

2. **§732(a) (1)** provides a general rule that a **partner's basis** in property received in a distribution **equals the partnership's basis in the property** immediately before the distribution.

   a. **§732(a)(2)** provides that if the **partnership basis** in the distributed **property** is **greater than** the **partner's basis** in the partnership interest, then the **basis amount in the property is limited to the partner's basis in the partnership prior to the distribution**.

**EXAMPLE 1:** A partnership distributes a parcel of land with an adjusted basis of **$24,000** to Don, who is a **50%** owner.

The land has a **FMV of $45,000**. Therefore, if the land had been sold by the partnership, **then** there would be a gain of **$21,000**.

Prior to the distribution of the land Don has a basis in his partnership interest of **$30,000**.

**On the distribution, the partnership recognizes no gain.**
When Don receives the land he has no gain. His basis in the land will be a carryover basis from his basis in his partnership interest. Therefore, his basis in his partnership interest is decreased by $24,000 and his remaining basis in his partnership interest is $6,000.

<table>
<thead>
<tr>
<th>Basis Prior to Distribution</th>
<th>Basis After Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership Interest</td>
<td>$30,000</td>
</tr>
<tr>
<td>Land Basis</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total Basis of Assets Owned</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>

This allows for a deferral on the appreciation of the property to Don. Don will not recognize any gain on the land until he disposes of it in a taxable event.

**EXAMPLE 2:** If in Example 1 above the partnership had an adjusted basis in the land of $45,000 instead of $24,000 then Don would have a limited basis in the land to the extent of his basis in his partnership interest of $30,000 and his remaining basis in his partnership interest would be zero.

<table>
<thead>
<tr>
<th>Basis Prior to Distribution</th>
<th>Basis After Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership Interest</td>
<td>$30,000</td>
</tr>
<tr>
<td>Land Basis</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total Basis of Assets Owned</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>

Don now has a zero basis in his partnership interest therefore any loss passed through from a Schedule K-1 would be limited.

3. §731(a)(1) provides that if money is distributed and the amount of money exceeds the adjusted basis of the partners' interest in the partnership then gain is recognized and it is characterized as capital gain.

4. 731(b) provides that no gain or loss shall be recognized by the partnership on a distribution of property to a partner, including money.

**EXAMPLE 3:** The partnership above distributes $24,000 cash to Don instead of land when his basis is $30,000. The $24,000 is characterized as a return of capital and therefore is tax free.

<table>
<thead>
<tr>
<th>Basis Prior to Distribution</th>
<th>Basis After Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership Interest</td>
<td>$30,000</td>
</tr>
<tr>
<td>Cash</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total Basis of Assets Owned</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>
EXAMPLE 4: If the asset distributed in Example 2 above was cash of $45,000 instead of land with a FMV of $45,000 then Don would have a capital gain of $15,000.

| Amount Realized on Cash Distribution | $45,000 |
| Less: Adjusted Basis of Partnership Interest | (30,000) |
| Equals: Capital Gain | $15,000 |

<table>
<thead>
<tr>
<th>Basis Prior to Distribution</th>
<th>Basis After Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership Interest</td>
<td>$30,000</td>
</tr>
<tr>
<td>Cash</td>
<td>-0-</td>
</tr>
<tr>
<td>Total Assets Owned</td>
<td>$30,000</td>
</tr>
<tr>
<td>Gain Recognized</td>
<td>$-0-</td>
</tr>
</tbody>
</table>

Tax Professional Note: Because of the provision of §731(b) the partnership does not recognize and gain on this transaction.

D. Contributed Property Subject to Debt > Basis Rule: §731(a)

§731(a) provides that if contributed property is subjected to liabilities in excess of its adjusted tax basis then the contributing partner may be subjected to gain recognition since a partner’s basis cannot be less than zero.

EXAMPLE: Same details as in Example 2 page 51 except the mortgage relief debt is $300,000 instead of only $84,000. Don’s capital account and adjusted tax basis are calculated as follows:

| Adjusted Basis of Property Contributed | $100,000 |
| Less: Debt Assumed by Partnership     | (300,000) |
| Equals: Subtotal in Capital Account   | (200,000) |
| Plus: Don’s 1/3 Share of Debt         | 100,000   |
| Equals: Subtotal Before Gain Recognition | (100,000) |
| Plus: §731(a) Gain Recognized         | $100,000  |
| Equals: Tax Basis in Partnership Interest | $-0-    |

Since §731(a) prevents a negative basis Don will recognize $100,000 of gain which also increases his adjusted basis. His Schedule K-1 capital account reconciliation reflects a negative capital account of ($200,000). Question F reflects Don’s $100,000 share of partnership debt. The tax professional preparing the Form 1065 should footnote Don’s ($200,000) ending capital account balance to caution the reader of the Schedule K-1 that this could result in a taxable gain to Don.
NOTE: The $100,000 of taxable gain that Don is required to report is not partnership income and should not be reported as a line item on Don’s Schedule K-1. Don will need to report this event on his Schedule D of his Form 1040.

E. New Partner’s Basis from Pre-Existing Partnership Liabilities

1. If there are liabilities on the partnership books prior to a new partner’s admission to the partnership then the contributing partner is deemed to contribute cash to the allocable share of those liabilities.

2. The contributing partner’s tax basis in the partnership interest is increased by the allocable share of the partnership’s pre-existing debt. This increase is recorded in the debt allocated in Question F of the Schedule K-1.

EXAMPLE: Assume the same facts as in the Example above in D except the partnership has $450,000 of other liabilities at the time of Don’s admission to the partnership. Don’s adjusted basis is calculated as follows:

\[
\begin{align*}
\text{Adjusted Tax Basis of Contributed Property} & \quad \$100,000 \\
\text{Less: Debt Assumed by Partnership} & \quad (300,000) \\
\text{Equals: Capital Account Balance} & \quad (200,000) \\
& \quad \text{Plus: Don’s 1/3 Share of Debt Assumed on Property} \quad 100,000 \\
& \quad \text{Don’s 1/3 Share of Pre-existing Debt} \quad 150,000 \\
\text{Equals: Adjusted Tax Basis in Partnership} & \quad \$ 50,000
\end{align*}
\]

Don’s Schedule K-1 capital account reconciliation reports a negative ($200,000) while “Other” Debt in Question F reports $250,000 for a total adjusted tax basis of $50,000.

NOTE: The other partners will have a decrease in their basis as the result of Don’s increase in basis. If the decrease is greater than their adjusted basis then they would recognize capital gain.

F. Contribution of Recapture Property

1. While §721 provides for no recognition of gain on the contribution of property, the property itself will need to be tracked for purposes of §704(c).

EXAMPLE 1: Don owns §1245 property with a FMV of $25,000, a cost of $20,000 and $5,000 adjusted basis after depreciation. If Don had sold the property, then he would have recognized $15,000 of §1245 recapture and $5,000 of §1231 gain. The cost, accumulated depreciation, depreciation method and recovery period carryover to the partnership. When the partnership sells the property it may be required to recapture depreciation claimed by Don up to the amount of the gain on the sale based on the rules of §704(c). If the partnership
sells the property during the next year at the FMV of $25,000, after deducting another $100 of depreciation, then the calculation is as follows:

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>$25,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted Basis ($5,000 - $100)</td>
<td>(4,900)</td>
</tr>
<tr>
<td>Total Gain</td>
<td>20,100</td>
</tr>
<tr>
<td>Less: §1245 Recapture to Don</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Excess Gain</td>
<td>5,100</td>
</tr>
<tr>
<td>Less: §1245 Recapture Allocated to Partners</td>
<td>(100)</td>
</tr>
<tr>
<td>Equals: §1231 Gain to Don</td>
<td>$ 5,000</td>
</tr>
</tbody>
</table>

2. Recapture income could also arise on the contribution of property if debt is assumed on the transfer by the partnership.

**EXAMPLE 2:** Assume that the property in Example 1 above had $15,000 of debt attached to it. Don will have a 50/50 ownership. In this case Don would recognize recapture on the contribution as follows:

| Adjusted Basis of Property Contributed | $ 5,000 |
| Less: Debt Assumed By Partnership | (15,000) |
| Equals: Subtotal in Capital Account | (10,000) |
| Plus: Don’s ½ interest in Debt | 7,500 |
| Equals: Adjusted Basis Before Recapture | (2,500) |
| Add: §1245 Recapture: Net Debt Relief > Basis: §731(a) | 2,500 |
| **Adjusted Basis in Partnership Interest** | $ 0 |

The character of the gain on the property contribution is ordinary income since it is §1245 recapture.

3. It is also possible that when a partner contributes property it could be both recapture and nonrecapture property. **Reg. 1.1245-4(c)** provides that the character of any gain recognized on the contribution because of debt assumption will be allocated based on the relative FMV of each property.

**EXAMPLE:** For a ½ interest Don contributes nondepreciable property and depreciable recapture property as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
<th>Debt</th>
<th>Debt &gt; Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nonrecapturable</td>
<td>$20,000</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Recapturable</td>
<td>30,000</td>
<td>5,000</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>$50,000</strong></td>
<td><strong>$15,000</strong></td>
<td><strong>$35,000</strong></td>
<td><strong>$20,000</strong></td>
</tr>
</tbody>
</table>
Don’s gain under §731(a) is calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Basis in Contributed Property</td>
<td>$15,000</td>
</tr>
<tr>
<td>Less: Debt Assumed By Partnership</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Equals: Subtotal in Capital Account</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Add: Debt Allocated to Don</td>
<td>17,500</td>
</tr>
<tr>
<td>Equals: Adjusted Basis Prior to Gain Recognition</td>
<td>(2,500)</td>
</tr>
<tr>
<td>Add: Gain Recognition: §731(a)</td>
<td>2,500</td>
</tr>
<tr>
<td><strong>Adjusted Basis in Partnership Interest</strong></td>
<td>$ 0.00</td>
</tr>
</tbody>
</table>

Portion of Gain Subject to §1231 Capital Gain: $2,500 \times \$20,000 = $1,000
Portion of Gain Subject to §1245 Recapture: $2,500 \times \$30,000 = $1,500

§731(a) Total Gain $2,500

VIII. Taxation of Partnership Losses and Pre- Contribution Gains and Losses

A. Loss Limitations: §704(d)

1. §704(d) provides that a partner’s distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner’s interest in the partnership at the end of the partnership year in which such loss occurred.

2. §704(d) also states that any excess of such loss over basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

3. Therefore, any excess loss over basis limitation is captured as a “carryforward” to subsequent tax years of the partner with an unlimited carryforward period.

4. There are three different limitations that apply to partnership losses that are passed through to a partner as follows:
   - The §704(d) limitation.
   - §465 At Risk Limitation where the losses are deductible only to the extent the partner is at risk for the partnership interest.
   - §469 Passive Activity Loss Limitations (PALs).
   - Only losses that first satisfy all of these applicable limitations are eligible to be deducted on a partner’s return.
EXAMPLE: Don is a limited partner in the AU partnership. On January 1 of the current year his basis was $50,000 while his at risk amount was $35,000. His share of the loss is $60,000 which is all passive. Don has another passive income producing investment that had $30,000 of passive income in the current year. Don’s deductible loss is limited to $30,000 even though his Schedule K-1 reports $60,000.

<table>
<thead>
<tr>
<th>Suspended or Applicable Provision</th>
<th>Basis</th>
<th>Deductible</th>
<th>Carryforward</th>
</tr>
</thead>
<tbody>
<tr>
<td>§704(d) Overall Limitation</td>
<td>$60,000</td>
<td>$50,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>§465 At-Risk Limitation</td>
<td>$35,000</td>
<td>$15,000</td>
<td></td>
</tr>
<tr>
<td>§469 Passive Activity Loss Limitation</td>
<td>$30,000</td>
<td>$5,000</td>
<td></td>
</tr>
</tbody>
</table>

B. At Risk Limitation: §465

1. Under the provisions of the at risk rules partnership losses that individual partners can deduct are limited to the amounts that are economically invested in the partnership.

2. §465(a) provides that invested amounts include the adjusted basis of cash and property contributed by the partner and the partner’s share of partnership earnings that have not been withdrawn.

3. If one or all of the partners are personally liable for partnership recourse debt then that debt is included in the adjusted basis of those partners. Those partners include the debt in their amount at risk.

4. As far as “nonrecourse” debt is concerned no partner carries any financial risk. Therefore, as a general rule partners cannot include nonrecourse debt in their at risk amount even though that debt is included in the adjusted basis of their partnership interest.

5. §465(b)(6) provides for an exception to this general rule with “qualified nonrecourse debt” which is defined as any financing which is borrowed by the taxpayer:

   a. With respect to the activity of holding real estate;
   b. From a qualified person, or represents a loan from any federal, state or local government or instrumentality thereof or is guaranteed by any federal, state or local government;
   c. With which no person is personally liable for repayment; and
   d. Which is not convertible debt.
6. This provision also states that a partner’s share of any qualified nonrecourse financing of such partnership shall be determined on the basis of the partner’s share of liabilities of the partnership incurred in connection with such financing.

- In summary, although the general rule provides that nonrecourse debt is not at risk, the exception for qualified nonrecourse debt deems that it is at risk.

**EXAMPLE 1:** Don invests $5,000 in the AU partnership with a 5% ownership interest. AU acquires fixed assets for $250,000. AU invested $50,000 and borrowed $200,000 from the bank by means of a recourse note. Assuming that Don’s share of the recourse debt is $10,000 (5% x $200,000) his basis is therefore $15,000 ($10,000 debt + $5,000 cash investment). Since the debt is recourse Don’s at risk amount is also $15,000.

If Don’s Schedule K-1 reports $11,000 of losses then Don is entitled to the full $11,000 of partnership losses because this is less than both his outside basis and his at risk amount.

**EXAMPLE 2:** Same facts as Example 1 above except that the bank note is nonrecourse because under the terms of the loan no partner is personally liable in the case of default. The fixed assets are the only collateral for the loan. In this case Don’s outside basis is still $15,000 but he can only deduct $5,000 of the loss reported on the Schedule K-1.

- The amount that Don is at risk for in the partnership is only his $5,000 cash investment. The nonrecourse debt is not at risk.

**NOTE:** If the property acquired had been real estate then the debt would have been qualified nonrecourse debt and Don would be at risk for $15,000.

C. Pre-Contribition Gain or Loss: §704(c)

1. §704(c)(1) provides a rule that certain income, gain, loss, and deductions with respect to property contributed to the partnership by a partner may not necessarily be allocated based on the partnership agreement or the distributive share based on each partner’s ownership interest.

2. If there is a contribution of property that has a “pre-contribution gain or loss” then this gain or loss must be allocated among the partners in order to properly account for the variation between the adjusted basis of the property and its FMV on the date of the contribution.

3. For nondepreciable property, this means that built-in-gain or loss on the date of the contribution must be allocated to the contributing partner when the property is eventually disposed of by the partnership in a taxable transaction.
EXAMPLE 1: Allocating Pre- Contribution Gain:

Don and Peter form a 50/50 partnership. Don contributes $10,000 in cash. Peter contributes land acquired more than a year ago with a FMV of $10,000 and an adjusted basis of $6,000 on the contribution date. Under the provisions of §723 for tax purposes the partnership has a carryover basis. After holding the land for 5 months the partnership sells it for $10,600. No other transactions took place. The following calculation is applicable to the sale:

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>$10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Adjusted Basis on Date of Contribution</td>
<td>(6,000)</td>
</tr>
<tr>
<td>Realized Gain</td>
<td>4,600</td>
</tr>
<tr>
<td>Less: Pre- Contribution Gain Under §704(c)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Post- Contribution Gain to be Allocated</td>
<td>$600</td>
</tr>
</tbody>
</table>

Because of the provisions of §704(c) Peter will be allocated the full $4,000 pre-contribution gain and $300 of the remaining gain. Don will receive $300 of the remaining gain since this is his allowable share of the post contribution appreciation. Therefore, each individual Schedule K-1 would report this special allocation of gain.

- §704(c) (1) (A) ensures that the partner contributing the property pays the tax on any built-in-gain. This prevents income shifting among taxpayers.

- Note: There is no corresponding provision for Subchapter S-Corporations. Gains and losses are allocated without regard to the pre-contribution gain or loss.

EXAMPLE 2: Allocating Pre- Contribution Loss:

Don and Peter form a 50/50 partnership and enter into a used car business. Don contributes a used auto with an agreed-upon $15,000 FMV and an adjusted basis of $20,000. Peter contributes $15,000 in cash. The partnership sells the contributed property in a retail sale for $14,250. §704(c) provides for the allocation of the pre-contribution loss and the post-contribution loss as follows:

<table>
<thead>
<tr>
<th>Selling Price</th>
<th>$14,250</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Adjusted Basis)</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Realized Loss</td>
<td>(5,750)</td>
</tr>
<tr>
<td>Pre- Contribution Loss Under §704(c)</td>
<td>5,000</td>
</tr>
<tr>
<td>Post- Contribution Loss to be Allocated</td>
<td>$ (750)</td>
</tr>
</tbody>
</table>

The entire pre-contribution loss of $5,000 and 50% of the post-contribution loss is allocated to Don. Therefore, Don’s Schedule K-1 will report a total loss of ($5,375) and Peter’s Schedule K-1 will report ($375) of loss.
D. Application of the Ceiling Rules

1. The “ceiling rule” is an important limitation on a partnership’s ability to allocate income, loss and deductions among partners.

2. Reg. 1.704-3(b) (1) states that the amount of income, loss and deduction that can be allocated to a partner for tax purposes cannot exceed 100% of the amount that the partnership actually recognizes for tax purposes.

3. Because of the “ceiling rule,” a partner cannot always be allocated tax items equal to the corresponding economic profit or loss realized by that partner.

EXAMPLE 1: Same factors as in Example 1 above except the selling price of the land is $9,900.

| Selling Price | $9,900 |
| Adjusted Basis | (6,000) |
| Total Realized Gain | 3,900 |
| (Less: Pre-Contribution Gain Limited to a “Ceiling”) | (3,900) |
| Remaining Gain | $ (0) |

Because of the limitations of the ceiling rule regulation the entire $3,900 is allocated to Don and nothing is allocated to Peter on the Schedule K-1.

- Sale of Pre-Contribution Gain Property for a Taxable Loss Using the Ceiling Rule

EXAMPLE 2: Same factors as in Example 1 above except the selling price of the land was $5,900 because of a decline in valuation and overbuilding in the area.

| Selling Price | $5,900 |
| Adjusted Basis | (6,000) |
| Total Realized Loss | (100) |
| (Less: Pre-Contribution Gain Limited to a “Ceiling Rule”) | (0) |
| Allocated Loss | $(100) |

Because of the limitation of the ceiling rule regulation the loss is allocated on the post-contribution decline in value.

No gain is available and the loss is allocated to each partner’s Schedule K-1.

E. Exception for Small Disparities

1. There is an exception to the “pre-contribution” rules under Reg. §1.704-3(e)(1) which states that a partnership is not required to apply the §704(c) rules to a partner’s contributions in a single year if both of the following are true:
a. The difference between the FMV and adjusted basis of all properties contributed by the partner during the year is 15% or less of the properties basis, and

b. The total disparity between the FMV and adjusted basis of all properties contributed by the partner during the year does not exceed $20,000.

2. Alternatively in the situation where a contribution qualifies for this small disparity rule the partnership may choose to allocate gain or loss under §704(c) only upon the disposition of property as opposed to not applying the §704(c) rules at all.

EXAMPLE: Don enters into the AU partnership by contributing equipment with a FMV of $219,000 and adjusted basis of $200,000. This is his only contribution for the year. The contribution qualifies for the “small disparity” rule because the disparity between the FMV of $219,000 and adjusted basis of $200,000 is $19,000. This is less than 15% of the basis of all the property of $30,000 that Don contributed during the current tax year. (15% times $200,000 = $30,000.)

3. Therefore, the AU Partnership has three choices for making tax allocations relating to the equipment contributed by Don as follows:

   • AU can ignore the §704(c) rules altogether.
   • AU can ignore the §704(c) rules when making allocations of depreciation deductions for the equipment contributed by Don but allocate the pre-contribution gain to Don when the asset is sold.
   • AU can choose to ignore the “small disparity exception” and fully apply the §704(c) rules as previously discussed.

Tax Professional Note: If a partnership disposes of §704(c) property in a nonrecognition transaction (e.g., §1031 exchange) then any substituted basis property received is treated as the §704(c) property since it is a continuation of the old investment. The property received is deemed to have the same amount of built-in-gain or loss as the §704(c) property transferred and the partnership must continue to use the same allocation method with respect to that property. (Reg. §1.704-3(a) (8)).

IX. Distributions In Liquidation of a Partnership Interest: §732

A. Partner’s Exit

1. §732(b) provides that the basis of property distributed by a partnership to a partner in liquidation of the partner's interest shall be equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.
EXAMPLE 1: A Partnership distributes the following assets to a partner in liquidation of the partner’s partnership interest:

**Partnership Basis in Assets:**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>20,000</td>
</tr>
<tr>
<td>Other Property</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total Distribution</strong></td>
<td><strong>$70,000</strong></td>
</tr>
</tbody>
</table>

**Partner’s Basis in Partnership Interest:**

<table>
<thead>
<tr>
<th>Basis Calculation</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Cash Received</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Balance</td>
<td>30,000</td>
</tr>
<tr>
<td>Less: Inventory Received</td>
<td>(20,000)</td>
</tr>
<tr>
<td><strong>Remaining Balance allocated to Other Property</strong></td>
<td><strong>$10,000</strong></td>
</tr>
</tbody>
</table>

Note: The partner has no remaining ownership interest in the partnership.

2. If the partnership’s adjusted basis in the **unrealized receivables** and **inventory** (“Hot Assets”) distributed is **greater than** the adjusted basis of the partner's interest (reduced by the money distributed in the same transaction) then the amount of the **basis is to** be divided among these items is in proportion to the partnership's adjusted basis of the items.

3. §732(c) provides that the **basis of distributed property** shall be **allocated first to unrealized receivables and inventory** in an amount **equal to the adjusted basis of each property** to the partnership and to the **extent of any remaining basis,** to any other distributed property **in proportion to** their adjusted basis to the partnership.

EXAMPLE 2: Partnership distributes the following assets to partner in liquidation of the partner’s partnership interest:

**Partnership Basis in Assets:**

<table>
<thead>
<tr>
<th>Asset</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$4,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>12,000</td>
</tr>
<tr>
<td>Unrealized Receivable</td>
<td>8,000</td>
</tr>
<tr>
<td>Other Property</td>
<td>22,000</td>
</tr>
<tr>
<td><strong>Total Distribution</strong></td>
<td><strong>$46,000</strong></td>
</tr>
</tbody>
</table>

**Partner's Basis in Partnership Interest:**

<table>
<thead>
<tr>
<th>Basis Calculation</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Less: Cash received)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Balance</td>
<td>$16,000</td>
</tr>
</tbody>
</table>

Basis to be allocated to inventory:

($12,000 divided by $20,000 [($12,000 + $8,000)]) x $16,000 = $9,600

Basis to be allocated to unrealized receivables:

($8,000 divided by $20,000) x $16,000 = $6,400

Basis Allocated to Other Property

$ -0-
Note: The partner has no remaining interest in the partnership

4. **Losses** will be recognized if money, unrealized receivables and/or inventory is distributed and the partner’s basis exceeds the money, receivables and inventory.

**EXAMPLE 3: Partnership distributes the following assets to partner in liquidation of partnership interest:**

<table>
<thead>
<tr>
<th>Partnership Basis in Assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$4,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>12,000</td>
</tr>
<tr>
<td>Unrealized Receivable</td>
<td>8,000</td>
</tr>
<tr>
<td><strong>Total Distribution</strong></td>
<td><strong>$22,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Partner's Basis In Partnership Interest:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Cash</td>
<td>(4,000)</td>
</tr>
<tr>
<td><strong>Balance</strong></td>
<td><strong>$26,000</strong></td>
</tr>
<tr>
<td>Less: Inventory</td>
<td>(12,000)</td>
</tr>
<tr>
<td><strong>Balance</strong></td>
<td><strong>$14,000</strong></td>
</tr>
<tr>
<td>Less: Unrealized Receivables</td>
<td>(8,000)</td>
</tr>
<tr>
<td><strong>Capital (loss) to Partner</strong></td>
<td><strong>($6,000)</strong></td>
</tr>
</tbody>
</table>