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# Business Entity Taxation Overview

* C Corp (“Double Tax”)
  + The corporation pays tax if it earns a profit.
    - IRC § 11 governs corporate taxation.
    - The rates are high and the brackets are skinny.
  + If the corporation distributes profits to the shareholder, then the shareholders are also taxed.
    - § 61: dividends are income.
    - Dividends are taxed at capital gains rates under § 1(h)(11).
    - But see, § 1411: high-income individuals also pay 3.8% healthcare tax on dividends.
  + This means, at its maximum, corp. profits can be taxed at 48% rate.
  + Losses
    - Shareholders may lose stock value, but it’s only deductible when the tock is sold and only if it’s lower than shareholder basis.
    - The corporation may take a deduction for losses on its tax return.
* S Corp
  + Governed by subchapter S, § 1361 et seq.
  + Taxed a lot more like partnerships than c corps.
    - Not taxed on profits, § 1363
    - Profits and losses pass through to the shareholders, § 1366
* Trusts
  + Grantors are not taxed on the income to the trust, but only if they retain absolutely NO interest in the trust.
  + Either the beneficiaries pay tax or the trust pays tax.
    - If the income is not distributed within the year, then it is taxed to the trust.
    - If the income is distributed within the year then it is taxed to the beneficiaries.

# Choice of Entity Question

## Defining a Partnership §§ 761 and 7701(a)(2)

* **From § 7701 (a)(2) Partnership and partner:** “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, which carries on a business, financial operation, or venture and isn’t a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization.
* **From § 761 (a) Partnership**: For purposes of this subtitle, the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.
* **Treated as mere co-ownership**: Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of—
  + (1) for investment purposes only and not for the active conduct of a business,
  + (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or
  + (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,
  + if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.
* **Reg. § 301.7701-1(a)(2)**: Certain joint undertakings give rise to entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.
  + **Joint Undertaking Merely to Share Expenses**: doesn’t create a separate entity – i.e. two persons jointly construct a ditch to drain surface water.
  + **Mere Co-Ownership of Property For Rent**: This doesn’t create a separate entity for tax purposes even if they maintain and keep it in repair.
  + **Co-Ownership with Services**: a separate entity exists if co-owners of an apartment building lease space AND provide services to the occupants either directly or through an agent.
* **Podell v. Commissioner:** Court identifies elements of a joint venture:
  + (a) contract showing intent of business venture establishment;
  + (b) agreement for joint control and proprietorship;
  + (c) a contribution of money, property, and/or services; and
  + ***(d) a sharing of profits. (This is most important factor)***
* **Problem Examples**:
  + **(a)** A B and C buy a parcel of land as tenants in common and hold the land as an investment. This is not a partnership - mere co-ownership of property does not give rise to a partnership. This is explicitly an example here.
  + **(b)** Same as (a), but they subdivide the property and A B and C sell the sub lots. Looking at the Podell Case below, this is probably enough to be considered a joint venture and thus this is likely to constitute a separate entity. The act of subdividing would often be enough.
  + **(c)** Two lawyers share an office and a secretary. Each services and bills his own individual clients. Unlikely. This is more akin to the 'constructing a ditch' example. One key to this is profit sharing - here, they are not dividing their profits. This doesn't meet the first definition of "partnership".
  + **(d)** Doctor will locate and purchase a building, architect will remodel it. When the work is done, the building will be sold by the doctor-architect real estate company and architect will receive 25% of the net profits. This is definitely a partnership because you have a division of profit. Division of profit is crucial - division of gross revenue is not. Division of PROFIT is key.
  + **(e)** Same as above if the doctor retains 3 of the units as rental and the architect gets the last one. This is akin to the Allison case below. Taking out part of the property in kind is not dividing profits. This is more like taking a percentage of gross rather than profit. One crucial fact is that they're not dividing up the profit, rather the overall assets of the project. Likely no entity here.
  + **(f)** Fisher will purchase and operate a fishing boat. Lender provides 10 year nonrecourse loan to Fisher. The arrangement will be evidenced by a note secured by the boat which will require repayment of the principal sum ratably over the 10 year period. In addition, lender will receive 15% of Fisher's net profits from the fishing operation each year of the arrangement. This probably isn't a partnership. However this is close. If they had called this a partnership, it very well might have been called a partnership.

## Defining a Corporation (§7701(a)(3))

* (3) Corporation: The term “corporation” includes associations, joint-stock companies, and insurance companies.
* So, this doesn't give you much other than when dealing with these specific business types. Further, the state law that says whether you're a corporation is persuasive, but not binding for tax purposes.

## Reg. § 301.7701-2 Business Entities; definitions.

* **(a) Business entities**. For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.
* **(b) Corporations.** For federal tax purposes, the term corporation means—
  + (1) A business entity organized under a Federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; ***[So, if state law refers to the company as a corporation, then it's automatically a corporation for tax purposes.]***
  + (2) An association (as determined under § ***301.7701-3***);
  + (3) A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;
  + (4) An ***insurance company;***
  + (5) A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended, 12 U.S.C. 1811 et seq., or a similar federal statute;
  + (6) A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in § 1.892-2T;
  + (7) A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and
  + (8) Certain foreign entities—***[corporations in other countries]***
  + ***[This is a complete list - if you're not under this list, you are not a corporation.]***

## Check the Box Regs: Reg. § 301.7701-3 Classification of certain business entities

* **(a) In general.** A business entity that is not classified as a corporation under § 301.7701-2(b) (1), (3), (4), (5), (6), (7), or (8) (an eligible entity) **can elect its classification for federal tax purposes as provided in this section**. An **eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership**, and an **eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner**. ***[So, this allows the business to elect to be taxed as a corporation or partnership (or sole proprietorship).]***
* **(b) Defaults (no election)**: Domestic eligible entities will be considered a partnership if it has two or more members; or disregarded as an entity separate from its owner if it has a single owner.

## Changing Tax Treatment Reg. § 301.7701-3(g)

* An elective change in classification will result in:
  + **Partnership to Association**: Partnership contributes all assets and liabilities to the association in exchange for stock in the association. The partnership then liquidates by distributing the stock of the association to its partners.
  + **Association to Partnership**: The association distributes all of its assets and liabilities to shareholders in a liquidation. The shareholders then contribute all distributed assets and liabilities to a newly formed partnership. [Note: This is a heavily taxed transaction.]

## Publicly Traded Partnerships - § 7704

* (a) General Rule: Publicly traded partnership is treated as a corporation.
* (b) Defines PTP: Any partnership if such interest are traded on an established securities market or interest in such partnership are readily tradable on a secondary market.
* (c) Exception: 90% or more of the company’s gross income must come from qualified income as defined by (d).

## Social Security and Medicare Taxes

* Employer/Employee Situation:
  + 6.2% Social Security tax for employer and employee
  + 1.45% Medicare tax for employer and employee
  + No Personal Exemption
  + Social Security Wage Base for 2015: $118,500 – this is the capped social security wage tax amount
* Self Employment
  + 12.5% social security tax
  + 2.9% medicare tax
  + Tax base: 92.35% of net earnings from self-employment
  + Filing threshold: $400 of net earnings from self-employment
  + Social security base for 2015: $118,500 minus wages
* Medicare Surtax: After $200k ($250k for married, joint return) of wages, compensation, or self-employment income, taxpayer pays an additional 0.9% in Medicare surtax.
* Medicare Taxes on Net Investment Income
  + 3.8% of net investment income
  + Applicable only to extent adjusted gross income is greater than $200,000 ($250,000 married)
  + Applicable to investment income (dividends, interest, recognized gains on stocks, bonds) income from financial trading business, and passive activity income
  + Not applicable to income from non-rental, non-financial-trading business activities in which taxpayer materially participates
  + Not imposed on wages or self employment income
  + This is § 1411.
* Choice of Entity Consideration:
  + Partnerships and Wages: Wage tax is not applicable to partners in a partnership
  + Partnerships and Self-Employment Tax: Self-employment tax is imposed on pass through income from partnership business to general partners (NOT imposed to limited parters)
  + S-Corporations Pass-Through Income: Self-employment tax is NOT imposed on pass-through income from S corporations to shareholders
  + S-Corporations Wages: Wage tax is imposed on S corporation shareholders only to the extent of wages paid.

If you don’t take out wages, you never have to pay SS/Medicare taxes – however, the IRS will look at blatantly evasive actions – you’re supposed to take out a ‘reasonable’ wage.

## Ordinary Trusts v. Business Trusts Reg. § 301.7701-4

* Trusts are not pass-through entities - they are single tax, but not exactly pass-through. When a trust earns income, that is taxed to the trust if the trust accumulates it. If it distributes to the beneficiaries, just the beneficiaries pay the tax.
* (a) Ordinary trusts. In general, the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement....
* (b) Business trusts. There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. **[So, if they are carrying on a business, it's not a trust anymore and is instead a business entity under -2 or -3.]**

# Formation of a Partnership

## Contributing Property In Exchange for Interest of Partnership

* **General Rule § 721(a):** No gain or loss recognized to a partnership or partners in the case of contribution of property to the partnership in exchange for an interest in the partnership.
  + "**Goodwill**" is property for § 721 purposes.
  + **Receivables** are property for §721 purposes.
  + **Investment Company Exception §721(b)**: Gain WILL be recognized on a transfer of property to a partnership which would be treated as an investment company (defined in §351). A transfer will be considered a transfer to an investment company if (**Reg. § 1.351-1(c)**):
    - (i) The transfer results in diversification of the transferors' interests; and
    - (ii) The transferee is:
      * (a) a regulated investment company;
      * (b) a real estate investment trust;
      * (c) a corporation more than 80% of the value of whose assets are held for investment and are readily marketable stocks or securities, or interest in regulated investment companies or real estate investment trusts.
    - **Treatment of Money as Securities § 351(e)**: The biggest problem is that § 351(e) considers money as securities for this evaluation. Thus, ***at least 20% of the assets cannot be money or stocks and other equity interests in a corporation or §351 will consider this a transfer to an investment company and gain will therefore be recognized***.
* **Partner's Basis of Interest § 722:** The basis of an interest in a partnership acquired by a contribution of property, including money, shall be the amount of such money and the carry-over basis of such property contributed plus any gain recognized under § 721(b).
* **Holding Period § 1223**: This only applies to capital gain (§1231) type assets that would recognize long term capital gain (more than 1 year). The holding period will tack onto the partner's interest as well as the partnership's assets.
* **Partnership's Basis of Contributed Property § 723**: Basis of property contributed is the carry-over basis plus any amount of gain recognized by the contributing partner under § 721(b).
  + **Assumption of Liability Greater than Contributing Partner's Basis**: The partnership will not receive inside basis increase when the partnership assumes a liability and the partner recognizes a gain on that assumption of liability. This will create an inside-outside basis discrepancy unless they make an election under §754. If there is a §754 election, the basis of the contributed property is increased by the gain recognized to the partner.
* **Special Rules**:
  + **("1245 Property") Property (Not Real) That Was Depreciated § 1245**: The depreciation you took here was ordinary, so 1245 would normally recapture the gain and prevent you from ignoring such gain. However, § 721(b)(3) negates this effect and §1245(b)(3) creates such exception provided there is a transferred basis in the contributed property. This doesn't get rid of the potential recapture as § 1245(a)(2) keeps this in the property through the definition of "recomputed basis".
    - **Holding Period**: The holding period will only transfer as to the adjusted basis of the capital asset transferred if the gain is due to depreciation.
  + **Installment Notes § 453B(a)**: 453B(a) requires the recognition of any gain realized on the disposition of an installment obligation. However, § 721 steps in again and allows the nonrecognition of the installment note gain.
  + **Encumbered Assets § 752(b)**: If the partner contributes assets that have a liability attached to the property, § 752(b) applies. The partner is treated as receiving a distribution of cash equal to the liability. Steps:
    - 1) First, apply the basic partnership formation rules: §§ 721, 722, 723
      * No taxation here and partner would get the carry-over basis of the contributed property.
    - 2) Then, deal with the liability: §752
      * **First, § 752(a) applies**: he gets an increase in his partner liability because he is liable for his portion of the assumed debt. This is treated a contribution of money by such partner in the partnership and therefore increases his outside basis by his share of the liability once it's in the partnership. The same goes for every other partners' bases as their liabilities go up by their share of the liability.
      * **Then, § 752(b) applies**: he gets a decrease in his partner liability because the partnership is assuming his individual liability. This is treated as a distribution of money to the partner by the partnership. Therefore, the partner's basis in the partnership interest decreases by the assumption of personal liability.
        + **Liability Assumption Greater than Carryover Basis + Liability Increase**: Here, if the liability is greater than the carryover basis plus his recent increase in partner share of liability, the remaining amount is considered a recognized gain. This partner's outside basis would therefore be 0.

**Nonrecourse Liability Here:**

**Reg. § 1.752-3(a)(2)**: We make believe that the asset is sold just for the amount of debt and then ask how much would be allocated to the contributing partner. The contributing partner thus is allocated the mortgage amount minus the basis in the property.

**Reg. § 1.752-3(a)(3)**: Then, the remaining amount moves to tier 3. This would allocate the remaining amount to each partner.

If the partner wants to avoid a gain here, the partner can also contribute cash equal to the amount of gain he would recognize or property with a basis equal to or greater than such amount. Or, the partners could agree that C continues to bear the economic risk of loss for the debt through an indemnity agreement.

* + **Contributing Assets and Obligations (e.g. Accounts Payable)**: Reg. § 1.752-1(a)(4) says that an obligation is a liability for §752 only if the obligation:
    - (A) Creates or increases the basis of any of the obligor's assets (including cash);
    - (B) Gives rise to an immediate deduction to the obligor; or
    - (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.
    - [**So, based on these definitions, accounts payable to a cash-method contributor are not considered a liability because they are deductible when paid; so, the contributing partner wouldn't have to worry about gain here with this kind of liability. Rather, he will simply be attributed the partnership gain as it is collected under § 704(c)(1). HOWEVER, if the contributing partner was on the accrual method he would have deducted this amount already and this could be considered a liability.]**
* Problem Examples Page 45,48, 52

## Contributing Services for Partnership Interest

* **Contributing Services for Initial Capital Account**: Under §83, the person performing the services has to report the FMV of the property as ordinary income. There are three steps here:
  + **1) Partnership Consequences**: Partnership is treated as if it conveyed a percent interest in its assets to the partner or performed the services. This is treated as if the partnership satisfied a debt with this interest and will therefore be treated as selling your property to your creditor. So, the partnership will realize a gain equal to the (Total Unrealized Gain on Assets) x (percent interest conveyed). HOWEVER, the partnership also gets a deduction under IRC §83 equal to the amount that the contributing partner reports as income.
  + **2) Other Partner Consequences**: Now, because the partnership has a gain on these assets, the other partners realize this gain as a pass-through gain respective of their distributive share. HOWEVER, because the partnership gets this deduction, the deduction passes-through to the partners. So, the outside basis of the partner remains the same.
  + **3) Recontribution of Property**: Now, we make believe that the partner that received the interest contributes that interest in the property of the partnership back to the partnership. This will be tax-free for both parties under §§ 721, 722, and 723 and will step up the basis by the realized gain.
* **Contributing Services for Share of Profits Going Forward (no Initial Capital Account)**: Under § 83, the partner performing services should be taxed now, but it's too difficult to value this at this point in time. Thus, it is not taxed now.
  + **Rev. Proc. 93-27**: If you perform services and get a profits only interest, then there is no taxation unless one of the three exceptions apply:
    - If the profit interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
      * Bogdanski doesn't think that an average is enough to meet the substantially certain test.
    - If within 2 years of receipt, the partner disposes of the profits interest; or
      * **Diamonds Case**: If you turn around and sell your interest right after you get it, you CAN realize this. Though, it will be a capital gain.
    - If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b) of the IRC.
* Problems Page 61, 75

## Single Person Entity to Partnership (Rev. Rul. 99-5)

* **Situation**: you have a single-member LLC and is currently a disregarded tax entity (tax nothing). What happens when someone else buys an interest in the LLC to become taxed as a partnership? Will she be taxed? Will it be treated as a partnership formation?
* In this ruling, there are two different ways to do this:
  + 1) Sell the new person part of your LLC interest.
    - Here, she gets the new person's money - shouldn't this be taxable?
    - **RULING**: This is a taxable event - she will be treated as selling new person one half of each of the LLC's assets and recognize gain/loss for each of those assets. For new person, we'll treat him as contributing the assets he just purchased to the LLC.
  + 2) Have him contribute money to LLC for new interest.
    - Here, she doesn't get new person's money, so should this be taxable?
    - **RULING**: We'll treat this as a formation of a new partnership - new person gets a cash basis in his interest at what he contributes.

## Organization and Syndication Expenses § 709

* **Placement Fee paid to Broker in selling partnership interests**: this is a "syndication expense" that is not deductible or amortizable as an organizational expense under §709.
* **Organizational fee paid to Developer to organize and negotiate the terms of the partnership**: This is an "organizational expense" under §709(b)(3) as defined under Reg. §1.709-2(a) to include fees for services "incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement."
* **Fees paid to Attorney to draft agreement and file necessary papers and prepare offering documents**: Fees related to the drafting of the partnership agreement and filing papers to form the partnership are "organizational expenses" and can be deducted. However, fees attributable to local securities "registration fees" and legal fees of an underwriter, placement agent or "issuer" for securities advice are "syndication expenses" and must be capitalized.
* **Accountant fees for preparing the financial projections in the offering documents**: "syndication expenses" and must be capitalized.
* **Printer fees to print the partnership offering prospectus**: Rev. Rul. 85-32 says this is a "syndication expense" that is not deductible or amortizable.
* **See Chapter 2 Answers for last 2. Problems Page 82.**

# Operations of a Partnership

## Partnerships Generally § 701

**Partners, not Partnership, Subject to Tax § 701**: A partnership is not subject to income tax; rather, the partners are liable for income tax in their separate capacities.

## Income to the Partners § 702

* **(a) Generally**: Each partner shall take into account their separate distributive share of the partnership’s gains and losses.
  + (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,
  + (2) gains and losses from sales or exchanges of capital assets held for more than 1 year,
  + (3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),
    - Stated separately because under §1231, you get a capital gain if sold at a gain, but an ordinary loss if sold at a loss.
    - **Depreciation Recapture §1245**: Depreciation overrides this making depreciation recapture ordinary income.
  + (4) charitable contributions (as defined in section 170 (c)),
    - Stated separately because there are different caps.
  + (5) dividends with respect to which section 1 (h)(11) or part VIII of subchapter B applies,
    - When one corporation receives a dividend from another, they are largely deductible by the recipient.
  + (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,
  + (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and
  + (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.
  + **Reg. § 1.702-1(a)(8)(ii)**: If it might be taxed differently, then state is separately.
    - E.g. this applies to the interest on a margin account. This is a broker lending the company money to buy securities. This is due to § 163(d) as investment interest - it is only deductible against investment income if you have any. We want this interest to pass through to the shareholders separately here so they can apply this to their net investment income for the year.
  + **See Problem Page 107 Answers for example of calculated income to partnership and separately stated income/deductions.**
* **(b) Character of Income**: Determined at the partnership level.
  + Inventory in the hands of Contributing Partner § 724: However, §724 would make this gain as if it was sold by a contributing partner.

## Income to the Partnership § 703

* (a)(1) The items in § 702(a) will be separately stated.
* (a)(2) Partnerships may not deduct:
  + Personal exemptions
  + Foreign taxes
  + Charitable contributions (though partners are allowed to deduct these)
  + Net operating losses
  + Individual itemized deductions
  + Deduction for depletion (for oil and gas wells)
* (b) Any elections must be made by all of the partners at the partnership level, except:
  + Discharge of indebtedness income
  + Mining deductions
  + Foreign taxes
* **Change in Partner's Basis §705(a)**: A partner's basis in his interest shall be:
  + **Increased** by the sum of his distributive share for the taxable year of:
    - taxable income of the partnership
    - tax-exempt income of the partnership
  + **decreased** by:
    - distributions by the partnership to the partner as provided by §733
    - the partner's distributive share for the taxable year of losses of the partnership
* **Limitation on Allowance of Losses §704(d)**: A partner’s share of distributive losses is only allowed 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. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership. [So, excess losses are not wasted - they go to a carryover account for when you get basis.]
  + **Avoid this limitation**: Simply have the partnership take out a loan - the loan will generate basis for the partners to use. Or, have the partner contribute property enough to offset the loss.
  + **Capital and Ordinary Loss In Excess of Basis**: The carry over basis for losses is proportional.
  + If an interest with a loss carryover account is transferred in a gift setting, it's unlikely that the donee will get the loss carryover account. No regulations on this, though.
* Problems Page 111
* **At-Risk Amounts - Limitation on Pass-Through Losses §465**: Individuals and certain C-corps can take losses only to the extent that the taxpayer is 'at-risk.' This is to prevent people from taking losses when the basis in their interest is generated out of non-recourse debt. Any losses past the 'at-risk' amount will carry forward, however.
  + **"At-Risk" Amount § 465(b)**: Moves up and down with income/loss and distributions just like outside basis. When you sell your interest, you do get to carry over the suspended loss. Calculated as the sum of:
    - Cash contributed
    - Basis of property contributed
    - Amount of debt for which the taxpayer is personally liable
      * Assume here that the partnership is worthless but all the partners are solvent
    - FMV of interest in property pledged as security for such borrowed amount (other than property used in such activity)
    - Any loans by partners to the partnership are not considered at risk amounts.
* **Limitation on Passive Activity Losses §469**: You cannot take losses from a passive activity against anything other than passive activity gains.
  + This includes rental activity.
  + Just like § 465, this does NOT apply to publicly traded corporations.
  + So this prevents people from taking these losses against anything other than passive gains.
  + There are ways to cope with this - if you are going to have passive losses, go buy something that has passive gains.
  + Active business losses, on the other hand, are deductible against everything.
  + "Passive Activity":
    - Trade or business in which the taxpayer does not materially participate, or rental (469(c))
    - Determined separately for each partner
    - Limited partners passive per se (IRC § 469(h)(2))
      * Includes non-managing LLC members
      * Regulations provide exceptions for active LPs and LLC members
    - Exception for real estate professionals - IRC §469(c)(7)
    - Exception for "Mom and Pop" rental house - IRC § 469(i)
    - So, there are Passive Income Generators (often rental properties) to absorb your losses.
    - Example:
      * We have an investor who makes 200k in his lawfirm and 40k from investments. He also has 8k passive income and 10k passive losses. Here, he can only use 8k deductions against his income, but the 2k extra just gets carried forward.
      * HOWEVER, these are available to offset your interest when you finally sell your passive income assets.
* **Schneer v. Commissioner**: We don’t tax partners on what they bring into the firm; rather, we tax them on what they’re entitled to take out under § 704.

## Partnership Taxable Year

* **Importance**: Under §706(a), the income passes through from the partnership to the partners at the end of the partnership's year. This means that the partners may be able to defer income a substantial amount of time if the partnership's taxable year is different than the partners'.
  + For **maximum deferral**, a calendar year of Jan 31 would be the best to get the full 11 month tax deferral. If there's going to be a bunch of losses, you want to **minimize the deferral** - you would use calendar year.
* **Reference to Partners § 706(b)(1)(B)**: Except as provided by (C), a partnership shall not have a taxable year other than:
  + **First) Majority Interest Taxable Year § 706(b)(1)(B)(i)**: Taxable year which constituted the taxable year of 1 or more partners having an aggregate interest in partnership profits and capital of more than 50 percent. This is tested on the 1st day of the partnership taxable year (without regard to this clause). If the partnership's taxable year changes by reason of this paragraph, it doesn't have to change again for either of the 2 taxable years following the year of change.
  + **Else) Principal Partners §706(b)(1)(B)(ii)**: if no majority interest taxable year, the taxable year of all the principal partners of the partnership. A principal partner is a partner having 5% or more share of profits.
  + **Else) Calendar Year § 706(b)(1)(B)(iii)**: otherwise it's the calendar year.
* **Business Purpose § 706(b)(1)(C)**: A partnership can have a taxable year regardless of (B) if it establishes a business purpose.
  + Deferral of income to partners is not a business purpose.
  + Time to gather tax info for its calendar year partners isn't likely a good business purpose either.
  + **Safe Harbor 25% test**: There is a business purpose if 25% or more of the partnership's gross receipts for the selected year are earned in the last two months. This test looks back to the three preceding years that correspond to the requested fiscal year. So there must be a 3 year pattern to use this 25% test.
* **§ 444 Election**: Regardless of everything thus far, the partnership can elect for a calendar year up to 3 months prior to calendar year (sept-nov) if they make a deposit for the tax due to remove the deferral of taxes under §7519.
* Problems Page 104

## Partnership Borrows Money or Reduces Debt § 752

* **(a) Increase in Partner's Liabilities**: Any increase in partner's share of liabilities or any increase in the partner's individual liabilities by reason of the assumption by the partner of partnership liabilities is considered as a contribution of money by such partner to the partnership.
* **(b) Decrease in Partner's Liabilities**: Any decrease in a partner's share of the liabilities of a partnership or decrease in a partner's individual liabilities by reason of the assumption by the partnership shall be treated as a distribution of money to the partner by the partnership.
* **Debt Allocation Reg. § 1.752-3(a)**: Nonrecourse liabilities generally are allocated according to the ratio in which the partners share profits.
* **Recourse vs. Nonrecourse Reg. §1-752-1(a)**:
  + **(1) Recourse Liability**: Partnership liability is recourse to the extent that any ***partner*** or related person bears the economic risk of loss for that liability.
    - **Recourse and Limited Liability (Reg. § 1.752-2(a))**: In the case that only some partners (general partners) are liable for the loan, they will be allocated the liability because they bear the economic risk of loss for this liability.
  + **(2) Nonrecourse Liability**: Partnership liability is a nonrecourse liability to the extent that no ***partner*** or related person bears the economic risk of loss for that liability.
    - **Nonrecourse and Limited Liability (Reg. § 1.752-3(a))**: Even if only some partners (general partners) are liable for the loan itself, this is a nonrecourse loan, so the partners are equally allocated the liability.

## Partnership Distributes Money to Partners

* **Non-Taxable Event §731**: Gain is not recognized to the partner unless the money exceeds their basis.
* **Partner's Basis in Interest §733 and § 705(a)(2)**: When a partnership distributes money to a partner (other than in liquidation of the partner's interest), the basis in the interest is **reduced by the amount of any money distributed and the amount of the basis to such partner of distributed property** other than money (as determined under §732).

## Partnership Sells Asset

* **Generally §704(a)**: Look to the partnership agreement. The gain or loss is split between the partners in their distributive amounts. Any gain or loss increases or decreases the partners' capital accounts and outside bases.
* **Contributed by Partner with Built-in Gain §704(c)**: When a partnership sells an asset contributed by a partner that had built in gain on it, the built in gain is taxed to the contributing partner for the amount of that built in gain. The remaining amount is split between the partners in their distributive amounts.
  + **Contributing Partner's Capital Account**: The contributing partner's capital account doesn't go up from the 704(c) gain either because it was already accounted for in the contribution. It does, however, increase the contributing partner's outside basis by the 704(c) amount.
* **Contributed Receivables §724(a)**: Any gain or loss shall be treated as ordinary income or ordinary loss.
* **Contributed by Partner Which was Inventory In Hands of Partner § 724(b)**: any gain or loss recognized by the partnership during the 5 years period starting after contribution shall be treated as ordinary income or loss. (i.e. real estate in the hands of a real estate trader)
* **New Partner After Asset has Gain**: If a new partner is introduced to the partnership and an asset already has gain built from being in the partnership, the new partner will not be taxed under §704(c) principles.

## Partnership Revalues Assets § 1.704-1(b)(2)(iv)(f)

* Under this reg, the partnership may revalue its assets on the occurrence of several events (including a new contributing partner) if it meets various requirements under Reg. § 1.704-1(b)(2)(2)(iv)(f)(5). The partners will increase their capital accounts by any appreciation from the book value, but the assets basis does not go up and the partners' outside bases don't go up.
  + **New Partner and Partnership with Liabilities**: If a new member is added, the liabilities are re-allocated according to the partner interests and this will adjust the outside bases of the partners because of the increase and decrease of a partner's share of liabilities under § 752.
  + **New Partner in regards to Asset that already had gain**: If a new partner is introduced to the partnership and an asset already has gain built from being in the partnership, the new partner will not be taxed under §704(c) principles. The partners that were with the partnership while that gain was had will be taxed according to their distributive shares - also, if the partnership revalued their assets when the new partner came in and they sold the new asset, their capital accounts won't go up because it was already increased when they did the revaluing.

# Partnership Allocations

* **Generally Partnership Agreement §704(a)**: Generally, a partner's share shall be determined by the partnership agreement. However, §704(b) applies to prevent abuse or if the agreement doesn't provide for the allocation.
* **Limitation on Allocation § 704(b)**: A partner's distributive share shall be determined with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if:
  + 1) the partnership doesn't provide for the allocation; or
  + 2) the allocation to the partner under the agreement does not have substantial economic effect.
* **Orrisch v. Commissioner**: The Orrisches allocated all depreciation deductions to the Orrisches however, when the partnership would break up, each partner would get everything equally. The building depreciation would come out of each partner's account equally. The Orrischs were not suffering the economic loss of depreciation. Therefore, this did not satisfy §704(b).
* **Substantial Economic Effect Reg. § 1.704-1(b)(2)**: Two Part Analysis:
  + **Economic Effect (b)(2)(ii)**: Follow the requirements of (b) otherwise there will be a fact-based analysis.
    - (a) Consistent with the underlying economic arrangement of the partners. When there is an economic benefit or burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or burden.
    - **"The Big Three Requirements" (b)** An arrangement will have **economic effect** if it meets three requirements:
      * 1) The partners **maintain capital accounts** according to rules of (b)(2)(iv) of this section;
      * 2) Upon liquidation the **partners only get what's in their capital account**; AND
      * 3) If you have a **negative balance in your capital account, you are obligated to restore the balance to the partnership** by the end of the year.
        + **Reg. § 1.704-1(b)(2)(ii)(d) Alternate Test**: Instead of this last requirement, you can have a "***qualified income offset***" clause in agreement. See below.
  + **Substantial (b)(2)(iii)**: Even if you live up to the big 3 requirements, if the allocations don't really effect anyone's economics, then we'll ignore them for tax purposes. Essentially, if the tax allocation is helping one person and not harming another, it won't be substantial. They are trying to avoid two kinds of abuse:
    - **Shifting Allocations § 1.704-1(b)(2)(iii)(b)**: Simply adjusting the tax so that less tax is paid.
      * E.g. all the foreign source income is assigned to D (up to D's distributive share) who is a non-resident alien and doesn't pay taxes on foreign source income. This would be a shifting allocation and would not have substantial economic effect. This would be okay if instead ALL foreign income was assigned to D for his distributive share - rather than an amount UP TO his distributive share.
    - **Transitory Allocations §1.704-1(b)(2)(iii)(c)**: Simply allocating something that will be largely offset by one or more other allocations and there is a "strong likelihood" that such allocations and offsetting allocations will be made. (no strong likelihood after 5 years)You just need a reasonable possibility that this allocation could have an impact on bottom line economics for it to pass here.
* **Maintenance of Capital Accounts Reg. §1.704-1(b)(2)(iv)(b)**: The partners' capital accounts must be:
  + Increased by the amount of money contributed by him to the partnership,
  + Increased by the FMV of property contributed by him (net of liabilities that the partnership is considered to assume)
  + Increased by allocations to him of partnership income and gain including gain exempt from tax
  + Decreased by the amount of money distributed to him by the partnership
  + Decreased by the FMV of property distributed to him by the partnership
  + Decreased by allocations to him of expenditures of the partnership
  + Decreased by the allocations of partnership loss and deduction
* See Problem Set Page 160.
* **Qualified Income Offset Reg. § 1.704(b)(2)(ii)(d): Alternate Test** - the partnership agreement contains a "qualified income offset" if it provides that a partner who unexpectedly receives an adjustment, allocation or distribution will be allocated items of income and gain in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. **Essentially, if something causes an account to go below zero, they will report enough partnership income to bring their account back to zero. Most commonly, this is due to a distribution - if it causes your capital account to drop below 0, then you pay taxes on the negative amount.** 
  + **Economic Effect Equivalence Reg. § 1.704-1(b)(2)(ii)(i)**: Even if your partnership agreement doesn't spell this out, if state law gets you to the same place, then it's the same as if your agreement actually said that.
  + **Contributed Obligations to Pay Reg. §1.704-1(b)(2)(ii)(c)**: Also, when a partner contributes a promissory note for an amount, he gets a "constructive" bonus to his capital account equal to the promissory amount. It will be constructively treated as part of the capital account provided it becomes due if he leaves the partnership (within 90 days after partner liquidation at the latest).
* **Allocations Attributable to Nonrecourse Debt Generally Reg. § 1.704-2(b)**: When we've got allocations for nonrecourse loan deductions, the regulations pretty much allow the partners to do what they want.
  + **Amount of Nonrecourse Deductions Reg. §1.704-2(c)**: The amount of nonrecourse deductions allowed in a taxable year is the net increase in partnership minimum gain during the year.
  + **Partnership Minimum Gain Reg. §1.704-2(d)**: Amount of partnership minimum gain is determined by computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.
  + **Requirements To Be Satisfied Reg. § 1.704-2(e)**: There are four requirements to be deemed in accordance with the partners' interests:
    - 1) **Meet the big 3 requirements** or the first 2 and have a **qualified income offset** in agreement.
    - 2) These allocations **must line up with other allocations** that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.
    - 3) You must have a **minimum gain chargeback** provision in your agreement.
      * **Minimum Gain Chargeback Requirement Reg. §1.704-2(f)**: When the partnership is paying off the debt, the partnership will be paying that back out of income. That income must be allocated to the partners in the same way they are taking deductions. So, if the deductions are allocated 80/20 for a time and then switch over to a 50/50 allocation, it will be fine as long as the income that is used to pay for the debt on the property is allocated the same way.
    - 4) all **other allocations must be valid**.
  + Problems page 172.

## Allocating Sales or Exchanges of Contributed Assets § 704(c)

* **Allocations and Contributed Assets §704(c)**: The partner that contributed the asset takes the built-in gain or loss when it is sold.
* **Selling an Asset with Built-in Gain**: The entirety of the built-in gain is allocated to the contributing partner. Any excess is allocated to the partners according to their distributive share.
  + **Type of Gain § 724 (a)**: If the asset was an ordinary gain asset in the hands of the contributing partner (i.e. 751(d) inventory property), it will be ordinary gain for the contributing partner.
  + **Sold for Less than FMV at time of Contribution**: There are three methods for allocating this economic loss that, ideally, the partnership agreement chooses:
    - **Traditional Method ("Ceiling Rule" Reg. §1.704-3(b)(1))**: Under the traditional method, the gain on the sale will be allocated to the contributing partner. Although, this doesn't recognize that the partnership actually took an economic loss and it will create a disparity in the book/taxes.
    - **Remedial Allocation Method Reg. § 1.704-3(d)**: This would allow the partnership to elect to essentially recognize a loss on the disposition of the asset and then tax the contributing partner as if the asset was disposed of at the FMV at the time of contribution (full gain to contributing partner). This method is done by creating an offsetting remedial item in an identical amount and allocates it to the contributing partner.
    - **Traditional Method with Curative Allocations §1.704-3(c)**: The partnership under the traditional method may make curative allocations to fix this. So, initially, the gain will be entirely allocated to the contributing partner and then when further income comes into the partnership, it will be allocated entirely to the contributing partner until the 'economic loss' suffered by the partnership is cured.
  + **Reg. §1.704-3(b)(1)**: For section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery, the allocation of deductions attributable to these items takes into account built-in gain or loss on the property. For example, tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal book allocations to those partners.(See Problem 2 pg 192)

## Allocation of Partnership Liabilities

* Under §752, we pretend that the partners are borrowing the liability rather than the partnership and when the partnership pays off the debt, we make believe that the partners pay the debt off.
* **Recourse Liabilities Reg. § 1.752-2 "Doomsday" Scenario**: Run through the "Doomsday" scenario here where all of their property has no value and if the partners all had money and they all sued each other, how much does everyone have left to pay?
  + **Example 1**: A, B, and C form a partnership by contributing 20k each. They satisfy the big 3 requirements and allocate profits and losses 40% to A, 40% to B, and 20% to C. They then take out a 40k recourse loan to fund the purchase of 100k property. To figure out how § 752 allocates this loan's basis, we run the doomsday scenario:
    - Doomsday: The property is sold for nothing here which creates a 100k loss. According to the agreement, 40k of the loss goes to A, 40k to B, and 20k to C. Add these to the capital accounts and A has -20k CA, B has -20k CA, and C has 0 CA. Therefore, the basis would get allocated 20k to A and 20k to B.
  + **Example 2**: Same as example 1, but A contributes 10k, B contributes 20k, and C contributes 30k. In the doomsday scenario, A has a -30k CA, B has a -20k CA, and C has a 10k CA. However, there's only 40k liability to go around. Thus, it is proportionally allocated using a ratio of (40k / 50k). 30k x 4/5 = 24k and 20k x 4/5 = 16k. Therefore, A will receive 24k of the basis for this liability and B will receive 16k of the basis.
  + **Example 3**: Same as example 1, but A and B are limited partners who are not obligated to restore a capital account deficit, but the partnership agreement includes a qualified income offset? Here, when we run the doomsday scenario, and the property is sold for a 100k loss, the loss can only be allocated to A and B up to their capital accounts. Thus only 20k allocated to A, 20k allocated to B, and the remaining 60k is allocated to C. This drop's A's account to -40k. Therefore, the entire 40k basis jump from the liability will go to C.
  + **Example 4**: Same as example 3, but A contributes 15k stock to the partnership as security for the liability and all income on the stock is allocated to A. This stock contribution increases A's capital account to 35k. When the 100k loss is allocated, 35k is allocated to A, 20k will be allocated to B and the remaining 45k will be allocated to C. This brings A's CA to -15k, B's CA to 0, and C's capital account is reduced to -25k. Therefore 15k will be allocated to A and 25k will be allocated to C. This would be the same if A contributed a 15k note as security under the alternate test for economic effect because A is treated as bearing the economic risk of loss to that extent.
  + **Example 5**: Same as Example 3, except A personally guarantees the 40k liability. Because we assume that everyone has money, the guarantee has no effect. A would have a right of subrogation against the partnership which would in turn oblige C to pay. So, the basis is entirely given to C.
* **Nonrecourse Liabilities Reg. §1.752-3**: A partner's share of the nonrecourse liabilities of a partnership equals the sum of:
  + 1) Partner's share of partnership minimum gain.
  + 2) Partner's share of gain under §704(c).
  + 3) Partner's share of the excess nonrecourse liabilities determined in accordance with the partner's share of the profits.

## Allocations where Partners' Interest Vary Throughout Year

* **Disposition of less than entire interest § 706(c)(2)(B)**: The taxable year of a partnership shall not close with respect to a partner who sells or exchanges less than his entire interest in the partnership or whose interest is reduced.
* **Change in Interest § 706(d)(1)**: If during any taxable year there is a change in any partner's interest, each partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined by the use of any method prescribed by the secretary which takes into account the variation of interests during the year. Two Available Methods:
  + **Proration**: You can wait until the end of the year and prorate based on the interest during each day.
  + **Interim**: "Close the books" at each partnership ownership change and calculate the actual losses/gains.
  + **Example**: A, B, and C each own 1/3 of ABC Partnership. On October 31, C contributes additional property and thus gets an increase in his partnership share so that A and B now each own 25%, and C owns 50%. During this year, they have an operating loss of 24k.
    - **Proration Method**: Using the proration method, 10/12 of the loss is allocated with the first 1/3 each interest split and 2/12 of the loss is allocated with the 25/25/50 split. So, 20k is allocated 1/3 each and 4k is allocated 1k to A and B and 2k to C.
    - **Interim Method**: Let's say the loss was entirely accrued during the middle of the year. Using the interim method, the loss would be allocated 1/3 to each of the partners because they would look at the losses at the time of the interest change to see how to allocate it. 6.66k loss to each partner.
  + **Proration Required for Certain Deductions...**

## Allocations in Family Partnerships § 704(e)

* **Personal Service Income Allocation Prevention § 704(e)(2)**: In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor. This prevents a personal service allocation.
* **Income Splitting from Property §704(e)(1)**: A person is recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. So, the donee must get a capital account - if you try to give the donee a greater share of income than their capital account, this won't work.

# Transactions Between Partner and Partnership § 707

|  |  |  |
| --- | --- | --- |
| 702/731 | 707(a) | 707(c) |
| Could be capital gain | Rent, salary, fee, interest always ordinary income | Always ordinary income |
| Income "passes through" when reported by partnership | Cash-method partner not taxed until receipt | Income "passes through" when deducted by partnership |
| Basis shifts per IRC §705 | Partnership deducts unless capital expenditure | Partnership deducts unless capital expenditure |
| One tax maximum | Possibility of double taxation/basis | Possibility of double tax/basis |

* **Transaction can be one of 3 things:**
  + § 702/731: partner's share of income.
  + § 707(a): partner not acting in capacity as partner; or
  + § 707(c): partner getting guaranteed payments.
  + **Importance**: It matters when determining the type of income to the partner and whether it can be deducted by the partnership.
* **Partner not Acting in Capacity as Partner §707(a)**: If the partner engages in a transaction with a partnership other than in his capacity as a partner, the transaction shall be considered as occurring between the partnership and a stranger. Repercussions:
  + Rent and salary paid - this is always ordinary income
  + Income not taxed to cash-method service partner until paid
  + Partnership will get to take a deduction under §162 (unless it's a capital expenditure)
    - If it's a capital expenditure, the it will be double taxed - the partnership couldn't deduct this and each partner would pay taxes on the full pass through income and the partner who isn't acting in capacity as partner would receive further taxation on his income from the transaction.
  + **What would make personal service income 707(a)?**
    - Not "basic duties" of partnership
    - Little or no risk
    - Short-lived allocation
    - Payment close in time to services
    - Tax-avoidance motive
    - Special allocation large compared to regular allocation
  + **Reg. § 1.707-1(a) Examples**:
    - Loans of money or property by the partnership to the partner or by the partner to the partnership
    - The sale of property by the partner to the partnership
    - The purchase of property by the partner from the partnership
    - Rendering of services by the partnership to the partner or by the partner to the partnership
    - Where a partner retains ownership of property but allows the partnership to use such property for partnership purposes, i.e: to obtain credit or secure firm creditors by guaranty pledge or other agreement
    - The substance of the transaction governs rather than its form. However, the taxpayer will be stuck with whatever form they pick.
  + **Pratt v. Commissioner**: Two partners were paid management fees which were a percentage of rentals. The issue was that the taxpayers were cash-method while the partnership was accrual. This allowed the partners to defer tax payment. Held: they were performing the basic duties of a partner and were therefore acting as a partner.
    - **Important Factor: whether they are performing the basic duties of a partner.**
    - Further, if you're doing something unusual, it's more likely to be considered a capital expenditure which will be double taxed.
  + **Architect Partner - Problem 2 Example (Page 235)**:
    - A commercial office building constructed by a partnership is projected to generate gross income of at least 100k per year indefinitely.
    - Architect, whose normal fee for architectural services is 40k contributes cash for a 25% interest in the partnership and receives both:
      * a 25% distributive share of net income for the life of the partnership and
      * an allocation of 20k of partnership gross income for each of the first 2 years of the partnership operations after the property is leased.
    - The partnership expects to have sufficient cash available to distribute 20k to Architect in the first 2 years and the agreement requires such a distribution.
    - **This is a § 707(a) transaction because:**
      * The 20k/year of gross income looks like a fee
      * The allocation is only for 2 years.
      * There is a tax motive/advantage to treat it as pass through income
    - This is **NOT a §707(c) guaranteed payment** because this is based on gross income rather than without regard to income.
  + Legislative History Factors that Make a Transaction a §707(a):
    - Not "basic duties" of partnership
    - Little or no risk of not getting paid
    - Short-lived allocation
    - Payment close in time to service
    - Tax-avoidance motive
    - Special allocation large compare to regular allocation
* **Guaranteed Payments §707(c)**: To the extent determined without regard to the income of the partnership, payments to a partner for services or use of capital shall be considered as made to a stranger.
  + **Timing Purpose**: If you have a guaranteed payment, it's treated just like a § 707(a) payment for income vs. capital gain, but it doesn't change the timing. If you have a guaranteed payment,the partner has to report it as income as soon as the partnership deducts it or adds it to the basis even if the partner hasn't yet been paid.
  + **Example Problem 1 Page 246**: AB equal partnership earns 12k ordinary income and 8k LTCG.
    - (a) What if A is required to be paid 15k for services regardless of income. This will be considered a §707(c) guaranteed payment. A will report 15k ordinary income and the partnership will get this as a deduction. Thus, they will have an operating loss of 3k. This 1.5k loss passes through to each partner and a 4k LTCG passes through.
    - (b) Same as (a), but A's services relate to improvements on land owned by the partnership. This normally just goes into the basis of the property, so no deduction for the partnership. So, partnership will still have 20k income and A will have 15k ordinary income on top of this. The 15k of capital expenditure will go into the basis of the property.

## Sales/Exchanges of Property Between Partnership and Partner § 707(b) [Issue Spot This]

* A sale/exchange of property between a partnership and a partner can be treated as either a sale between the parties, or a combination of a contribution and distribution.
* **Determination of Exchange of Property § 707(a)(2)(B)**: this doesn't say much - it just indicates that there is an issue. There are some regulations on this: Reg. §§ 1.707-3 through -8. It basically lays out a smell test for whether it's a sale or a combination of a distribution and contribution. The regulations do set up a 2 year presumption. If a contribution and distribution are within 2 years of each other, they are rebuttably presumed to be related. But, outside of 2 years, you're fine. So, wait 2 years to be sure that it's not a sale.
  + **Sale between Partners § 707(a)(2)(B)**: Also, if one partner contributes property and another contributes money then the first takes out the money and the second takes out the property, this will constructively be treated as a sale between the two partners.
* If it is considered a sale, §707(b) applies:
  + **Losses Disallowed §707(b)(1)**: No deduction is allowed from sale or exchange of property between:
    - (A) a partnership and a partner owning directly or indirectly **more than 50 percent** of the capital interest or profits interest
    - (B) two partnerships in which the same persons own directly or indirectly, **more than 50 percent** of the capital interests or profits interest.
  + **Gains Treated as Ordinary Income §707(b)(2)**: A sale or exchange of property, which in the hands of the transferee is property other than a capital asset will have ordinary income gain if it is between:
    - (A) A partnership and person owning **more than 50 percent** of the interest in such partnership.
    - (B) two partnerships in which the same person owns **more than 50 percent** of the interest.

# Sale of a Partnership Interest

* **Generally §741**: Gain or loss shall be recognized to the transferor partner and will be considered a capital gain or loss except as provided in § 751.
  + **Transfer of Liabilities §752**: Don't forget that the basis in a partnership interest from partnership liabilities transfers with this interest to the buyer's.
* **"Hot Asset" Rules § 751**: The amount of money or FMV of property received by a transferor partner in exchange for his interest in the partnership will be ordinary income if attributable to:
  + 1) **unrealized receivables** of the partnership, or
    - **Unrealized Receivables § 751(c)**: includes rights to payment for goods delivered ( or to be delivered) to the extent therefrom would be treated as ordinary income, OR services rendered or to be rendered.
  + 2) **inventory items** of the partnership,
    - **Inventory Items § 751(d)**: includes:
      * 1) property of the partnership described in § 1221
      * 2) any other property which if sold would be considered an ordinary income
      * 3) any other property held by the partnership which, if held by the selling partner would be considered property which if sold would produce ordinary income.
  + **Problem 1 Page 271**: A owns a 1/3 interest in ABC partnership which manufactures and sells inventory. A, B, and C each made initial cash contributions of 75k. All income has been distributed as earned. On Jan 1, A sells his interest in the partnership to D. The partnership has the following Balance Sheet:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Assets | | | Partner's Capital | | |
|  | **Basis** | **FMV** |  | **Basis** | **FMV** |
| Cash | 45k | 45k | **A** | 75k | 135k |
| Inventory | 75k | 90k | **B** | 75k | 135k |
| Acc. Receivable | 0 | 45k | **C** | 75k | 135k |
| Capital Asset | 105k | 225k |  |  |  |
| TOTAL | 225k | 405k |  | 225k | 405k |

* + - (a) What if A sells his interest to D for 135k? Normally, under § 741, A would simply have a 60k gain. § 751 jumps in because we have hot assets here. The inventory and the accounts receivable are both hot assets. Therefore, we make believe the partnership sold all of the hot assets and determine how much ordinary gain A would receive. Here, the partnership would have 60k ordinary income from such a sale and A would have 20k ordinary income. Therefore, 20k of A's gain on his sale of the interest will be ordinary income and the rest will be capital gain.
    - (b) What if each partner originally contributed 150k and the capital asset has a basis of 330k and A sells his interest to D for 135k? Here, there would normally be a 15k capital loss under §741. However, 751 steps in to make him realize his share of the hot asset income (still 20k). Therefore, he will realize 20k ordinary income from the hot assets and 35k capital loss.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Assets | | | Partner's Capital | | |
|  | **Basis** | **FMV** |  | **Basis** | **FMV** |
| Cash | 45k | 45k | **A** | 150k | 135k |
| Inventory | 75k | 90k | **B** | 150k | 135k |
| Acc. Receivable | 0 | 45k | **C** | 150k | 135k |
| Capital Asset | 330k | 225k |  |  |  |
| TOTAL | 450k | 405k |  | 225k | 405k |

* + - (c) What if each partner originally contributed only 45k cash instead of 75k and the capital asset was purchased subject to a 90k liability? A sells his interest to D for 105k. This is the same as (a). A's amount realized is 135k (105k cash and 30k reduction of liability). His basis is 75k, so his total gain is again 60k and the 751 computation will result in the same 20k ordinary income from the hot assets and 40k capital gain.
    - (d) What if A sells her interest one quarter of the way through the year when A's share of the partnership income is 30k? D will pay A 165k and will acquire A's right to income. Under §706, she does have to report income for the first 3 months of the year because the partnership's taxable year closes as to them. So, here, A's basis would jump to 105k and the FMV of the interest would be at 165k. Therefore, the gain will still be 60k and the outcome will be the same as (a). 20k ordinary income and 40k capital gain.
* **Inside/Outside Basis Mismatch for Buyer**: When a partnership interest is sold, it results in the partnership's outside basis being higher than the inside basis of the assets inside the partnership.
  + **Treatment without Election §743(a)**: The general rule is that the basis of the partnership property shall not be adjusted as a result of an exchange of a partnership interest or on the death of a partner UNLESS they make a § 754 election (or unless the partnership has a substantial built-in loss immediately after such transfer).
  + **§ 754 Election**: If the partnership files an election, the basis of partnership property shall be adjusted accordingly:
    - Distribution of Property: Under § 734.
    - Transfer of Partnership Interest: under §743.
    - **Time and Manner of Election Reg. § 1.754-1(b)**
    - **Commitment of Election**: You can't revoke a 754 election without permission from the IRS.
  + **Treatment With Election § 743(b)**: In a transfer of an interest in a partnership by sale or exchange or upon death of a partner, a partnership with the 754 election shall increase/decrease the basis of the partnership property by the difference between the basis to the transferee partner of his interest in the partnership and his proportionate share of the adjusted basis of the partnership property. This boost in ***basis will increase with respect to the transferee partner only***.
  + **Forced because of Substantial Built-in Loss § 743(d)**: You can be forced to make the basis adjustment if there is a substantial built-in loss in the partnership. A partnership has a substantial built-in loss if the partnership's adjusted basis in the partnership property exceeds the FMV of such property by 250k.
  + **Allocation of Basis When Basis is Shifted § 755**: You apply it proportionately depending on the appreciation of each asset. The main goal of §755(a) is to minimize disparities between basis and FMV. You divide the assets into classes:
    - 1) capital assets and § 1231 property (LTCG)
    - 2) all other property (ordinary income)
    - Then, allocate basis adjustments based on relative appreciation in each class.
    - Problem 2 on 288 example.

# Operating Distributions

* **Partners Generally § 731(a)**:
  + (1) No **gain** shall be recognized except to the extent that any money distributed exceeds the basis of such partner's interest in the partnership.
  + (2) No **loss** shall be recognized to such partner unless there is a liquidation of a partner's interest and they receive no property other than money, unrealized receivables, and inventory. If there is a liquidation of the partner's interest loss is recognized to the extent of the excess of their basis in such interest over the sum of any money distributed, and the basis to the distributee of any unrealized receivables, and inventory.
* **Partnerships Generally §731(b)**: No gain or loss recognized on a distribution to a partner of property, including money.
* **Partner's Basis in Property Received in Non-liquidating Distributions §732(a)**:
  + (1) **Generally**: The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall be its adjusted basis to the partnership.
  + (2) **Limitation**: The basis to the distributee of property to which (1) applies cannot exceed the adjusted basis of the partner's interest reduced by any money distributed in the same transaction.
* **Example Problems Page 300**: ABC Partnership distributes 10k cash and land worth 10k with basis of 5k. A has a basis of 20k, B has a basis of 10k, C has a basis of 5k.
  + A will have no income here because his basis in his share is greater than the money and property he received. From §732, we know the basis in the property he receives is going to be a carryover basis. Also, from § 733, we know the basis in his partnership interest will be reduced by cash received and the 5k basis in the land. So, he will have 5k remaining basis in the partnership. The partnership will not be taxed under §731(b).
  + B will not have any income here because the money distributed doesn't exceed the basis of her interest in the partnership. However, because she doesn't have any remaining basis, B will not get any carryover basis in the land. § 732(a)(2) applies; the basis of the property cannot exceed the adjusted basis of the partner's interest in the partnership reduced by any money received in the same transaction. So, § 732(a)(2) prevents any basis from carrying over in this case. B will receive the property with 0 basis. Her basis in the partnership interest will also be 0.
    - Note that this creates an inside/outside basis mismatch here.
  + C will have 5k gain here under §731(a) because the money received exceeded the basis of his partnership interest. He will also have a 0 basis in the property transferred and a 0 basis in his partnership interest.
    - If C took out the land first - this would suck up all of his basis. Then, if he took the money out later, he would be hit with a 10k gain because he will have no basis. Though, he would have 5k basis in the property distributed.
  + **Note**: Every time that §732(a)(2) applies and every time a partner is taxed on a gain with a distribution, the inside/outside basis will not match.
* **Partner Draws Not Considered Distributions Reg. § 1.731-1(a)(1)(ii)**: Monthly draw are not distributions covered by 731 - this is basically a loan from the partnership. The understanding is that at the end of the year, the partnership will then make a distribution to the partner in that amount minus the draw amounts.
* **Mini 754 Election § 732(d) - (Good for Taxpayer)** if you have a partner getting a distribution of property (some kind of asset) and they had purchased their interest in the last 2 years, they can make their own mini 754 election just for them. (a) would normally apply, but (d) allows them to make the adjustment to said property regardless of whether the partnership makes the 754 election.
* **Securities Treated Like Money §731(c) - (Bad for Taxpayer)** If the partnership distributes marketable securities, this should be treated like money. Under § 731(a), the only way you can get income is if you have distribution greater than your basis. Congress is trying to recognize the fact that marketable securities are essentially money. There are exceptions in §731(c)(3).
  + §731(c)(3)(B) limits the amount recognized. Don't go here. No one knows what this exception is for. This is an issue spotter.
* **Taint of "inventory" property §735 - (Bad for Taxpayer)** if you take an ordinary income type asset out of the partnership, then it will produce ordinary income even if you sell it (and it wouldn't be ordinary income to you). For example, let's say the partnership sells real estate, but you do not personally (i.e. you're a dentist). It will still be ordinary income to you if the partnership distributes the property to you. If the distributee holds on to the property for 5 years, the 'taint' goes away.
* **Inside/Outside Basis Mismatch**: When analyzing the balance sheet, you look at the FMV of these assets rather than the book values. This requires an appraisal of all the assets of the partnership.
  + **Example Problems Page 309**: The ABC partnership has three equal partners and the following balance sheet. A receives CA #1 in an operating distribution. A has a one-ninth interest worth 20k in the partnership capital and the profits after the distribution.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Assets | | | Partner's Capital | | |
|  | **Basis** | **FMV** |  | **Basis** | **FMV** |
| Cash | 60k | 60k | **A** | 70k | 80k |
| Capital Asset #1 | 90k | 60k | **B** | 70k | 80k |
| Capital Asset #2 | 40k | 60k | **C** | 70k | 80k |
| Capital Asset #3 | 20k | 60k |  |  |  |
| TOTAL | 210k | 240k |  | 210k | 240k |

* + (a) Result to A and the Partnership if there is no §754 election? A would recognize no gain or loss here because A is not receiving any money. What about A's basis in the property? Normally the basis is carry over from the partnership, but A only has 70k outside basis. Therefore, A will take a basis haircut here dropping the basis of the asset to 70k. Also, A's basis in his interest will drop to 0. B and C would be unhappy here because that 20k basis that got burned belonged in part to them. However, now the inside and outside basis no longer match. After the distribution, this is what the balance sheet would look like:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Assets | | | Partner's Capital | | |
|  | **Basis** | **FMV** |  | **Basis** | **FMV** |
| Cash | 60k | 60k | **A** | 0 | 20k |
| Capital Asset #2 | 40k | 60k | **B** | 70k | 80k |
| Capital Asset #3 | 20k | 60k | **C** | 70k | 80k |
| TOTAL | 120k | 180k |  | 140k | 180k |

* + (b) What result if §754 election had been made before this distribution? The results to A are the same. Again, the partnership does not recognize its loss. However, the §754 election triggers an upward adjustment of 20k, equal to the distributed property's downward change in basis. This is allocated among the partnership assets by the §755 rules in proportion to the appreciation in the remaining properties. CA 2 has an appreciation of 20k. CA 3 has an appreciation of 40k. So, CA 2 takes 2/6 of the appreciation and CA 3 takes 4/6 of the appreciation. This means 6,666 appreciation goes to CA 2 and 13,333 goes to CA 3 ending in the following balance sheet:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Assets | | | Partner's Capital | | |
|  | **Basis** | **FMV** |  | **Basis** | **FMV** |
| Cash | 60k | 60k | **A** | 0 | 20k |
| Capital Asset #2 | 46,666 | 60k | **B** | 70k | 80k |
| Capital Asset #3 | 33,333 | 60k | **C** | 70k | 80k |
| TOTAL | 120k | 180k |  | 140k | 180k |

* **Contributed Property § 704(c) Assets ("Mixing Bowl" Rules)**: Property contributed with a built in gain is taxed to the contributing partner - you can't shift that built in gain to the other partners by distributing that asset out to other partners.
  + **Distribution of Contributed Property § 704(c)(1)(B)**: If any property so contributed is distributed by the partnership within 7 years of being contributed, the contributing partner shall be treated as **recognizing gain or loss from the sale of such property with FMV at time of contribution**.
  + Problems Page 314.
  + **Partner Contributes Appreciated Assets and Receives Other Assets §737 [Issue Spotter]**: Here, 737 applies and the partner shall be treated as recognizing gain equal to the lesser of:
    - The excess of FMV of property received over the basis of partner's interest in the partnership immediately before the distribution reduced by the amount of money received in the distribution; OR
    - The net precontribution gain of the partner.
  + Also, don't forget if you contributed property to a partnership and you take a distribution within 2 years, **§707 can make this a sale**.
* **"Hot Assets" § 751(b)**: If the distribution has the effect of changing the partner's share of those assets, the distributions will be treated as a taxable sale between the distributee and the partnership. You can't have one partner take out hot assets and other partners take out only cool assets.
  + Example Problems Page 324

# Liquidating Distributions

There are two ways to leave - either sale of partnership interest or bought out by partnership:

* **Sale of Partnership Interest**: Sell their interest to a new person or remaining partners - this is covered in Sale of a Partnership Interest above - 741 says this is a capital gain or loss unless there are hot assets.
* **Bought Out by Partnership**: Similar to an operating distribution, but:
  + **Basis Rules §732**:
    - **(b) Distributions in Liquidation**: The basis of property distributed by a partnership to a partner in liquidation of partner's interest shall be equal to the outside basis of such partner's interest reduced by any money distributed.
    - **(c) Allocation of Basis**: Two tier approach:
      * **Hot Assets First**: First, the basis first goes into any unrealized receivables and inventory items up to the adjusted basis of each such property in the partnership.
      * **Then To Other Assets**: Basis is added to the rest of the assets.
  + **Loss Recognition § 731(a)**: If you have leftover basis and all you get is cash, receivables, and inventory, then you can take an immediate capital loss on your partnership interest. Otherwise, the remaining basis is added to the other assets.
  + Example Problems Page 334
  + **Potential Guaranteed Payment § 736**:
    - § 736(a): Distributive share or guaranteed payment (income)
      * Applies if the partner gets more than their partnership share - this should not get run through §731/2 - this is really the other partners paying this person as if he was a stranger. This is good for the other partners because it's deductible.
    - § 736(b): Distribution rules
      * Says the distribution rules apply if the partner just gets their share.
      * Payments for partnership property.
    - What could trigger 736(a)?
      * Severance pay
      * Noncompetition payments
      * Insurance-type payments to disabled partner
    - Example Problem Page 347

## Liquidation of Entire Partnership

* If the entire partnership is being liquidated, there's no need for §736 analysis. A partnership can be liquidated in two ways:
  + Partnership actually liquidates
  + **Constructive Liquidation § 708(b)(1)(B)**: If there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 1-year period.
    - The regulations essentially say that a new partnership is formed.
    - Bogdanski doesn't think this is necessary and is fairly meaningless because there's no taxable events. The only thing he can think of is that **it gets rid of a §754 election**.

# Death of a Partner

* When a partner dies, their tax year ends. Further, the partnership taxable year closes for that partner and some income flows to that partner.
* There are three potential options:
  + The Estate succeeds decedent as partner
  + Partnership interest is sold as above in Sale of a Partnership Interest
  + Partnership interest is liquidated as above in Liquidation of a Partnership Interest
* **Issues**:
  + **Proration of Income**: The partnership year closes upon death of partner as to that partner, so they can either close the books or pro-rate the years results.
  + **Outside Basis**: The outside basis is stepped up (or down) under § 1014 except:
    - No inside basis step-up unless a §754 election is in place.
    - There is no step-up for income in respect of a decedent (§691)
      * We don't step up basis to income earned by decedent before they died but hasn't been reported yet. You can't use 1014 to cut off income earned by the decedent before they died. When the estate collects it, the estate must pay tax on it.
      * When grandma sold some property and it was in escrow when she died. The gain on this sale will be IRD, so this will be capital gain to the estate.
      * This rule applies to a partnership interest - when you die as a partner, any income that the partnership has earned but not yet received: your portion of that income will be subtracted out when the partnership interest transfers upon death.
* **Example Problem 403**: D is 1/3 general partner in the DEF partnership. D dies at a time when the partnership has earned 15k for the current year and his share of the partnership income for the year is 5k. Under all the sale agreements below, D is to be paid 30k for his interest which includes his share of income. Immediately prior to his death, DEF’s balance sheet looks like the following:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Assets | | | Partner's Capital | | |
|  | **Basis** | **FMV** |  | **Basis** | **FMV** |
| Cash | 9k | 9k | **D** | 3k | 30k |
| Cash Not Yet Accounted For | 15k | 15k | **E** | 3k | 30k |
| Receivables for Services | 0k | 45k | **F** | 3k | 30k |
| Depreciable 1245 Property | 0k | 3k |  |  |  |
| Goodwill | 0k | 18k |  |  |  |
| TOTAL | 24k | 90k |  | 9k | 90k |

* + When D dies, his taxable year ends and the partnership’s taxable year ends as to D’s interest. 5k of the 15k received this year will pass through to D. This increases D’s outside basis, but this outside basis dies with D.
  + The FMV of D’s interest is 30k, however we have IRD from the receivables. Therefore, the basis of the partnership interest is reduced by 15k.
  + **Partner’s Buyout D’s Interest**: Here, that 15k income attributable to the hot asset would be recognized by the estate as ordinary income. No matter how you do it, the partner here (D’s estate) will have 15k of income.
  + **Partnership (in which capital is a material income-producing factor) Liquidates D’s Interest**: If they take the receivable, then the hot asset rules will apply.
  + ***See Problem Answer for more in-depth analysis***.