QUIZ INSTRUCTIONS

PARTNERSHIP TAXATION - PART I

There are 7 true-false quiz questions and 23 multiple-choice questions at the end of the course. Choose the best answer based on the limited facts of each question, and record your answer on the enclosed answer sheets. An extra answer sheet is enclosed for your personal records. The answer sheet to be turned in is on the next page. **If you would like to complete the test on-line, go to www.cpelite.com and click “On-Line Testing.”**

You must score 70% to receive continuing professional education credit for this course. You may take the quiz two additional times without incurring additional expense.

**If your zip code is below 56000**, please return your completed answer sheet to CPElite, P. O. Box 721, White Rock, SC 29177-0721. **If your zip code is above 55999**, please return your completed answer sheet to CPElite, P.O. Box 1059, Clemson, SC 29633-1059. After you successfully complete the quiz, your quiz results, a complete set of solutions, and a certificate of completion will be mailed to you within 10 working days of our receipt of your answer sheet. The completion date on your answer sheet will be the date designated on your certificate. **The latest recommended completion date is within one year of purchase.**

ANSWER SHEET FOR YOUR RECORDS

PARTNERSHIP TAXATION - PART I

6 HOURS OF CPE

(Based on 50 Minutes of Average Completion Time Per Hour)

Delivery Method – Self Study

(Latest Recommended Completion Date: Within one year of purchase)

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1. _______  7. _______  13. _______  19. _______  25. _______
2. _______  8. _______  14. _______  20. _______  26. _______
3. _______  9. _______  15. _______  21. _______  27. _______
4. _______ 10. _______  16. _______  22. _______  28. _______
5. _______ 11. _______  17. _______  23. _______  29. _______
6. _______ 12. _______  18. _______  24. _______  30. _______

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3. _______ 9. _______ 15. _______ 21. _______ 27. _______
4. _______ 10. _______ 16. _______ 22. _______ 28. _______
5. _______ 11. _______ 17. _______ 23. _______ 29. _______
6. _______ 12. _______ 18. _______ 24. _______ 30. _______

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COURSE EVALUATION (Answer Yes, No, or N/A)

1. The stated learning objective was met. _____ 2. Handout or advance preparation materials were satisfactory._____ 3. The materials were accurate._____ 4. The materials were relevant and contributed to the achievement of the learning objective._____ 5. If applicable, prerequisite requirements were appropriate._____ 6. The time allotted to the learning activity was appropriate._____ 7. Additional Comments ________________________________________________________________
# PARTNERSHIP TAXATION - PART I
Recommended CPE Credit: 6 HRS [B]

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ONGOING DEVELOPMENTS

CPElite™ continues to monitor legislative, administrative, and judicial developments as they occur, and our courses are updated at least annually to reflect tax law changes.
PARTNERSHIP TAXATION - PART I

The primary objectives of this course are to provide an explanation of the (1) tax implications of formation, including gain or loss, basis of partnership interest, and basis of partnership assets after formation and (2) general reporting procedures of partnership items. This course reflects legislative changes made through the "Middle Class Tax Relief and Job Creation Act of 2012," signed by President Obama on February 22, 2012.

The level of knowledge expected to be imparted by this course is basic. Our courses comply with the enhanced standards required of providers of continuing professional education (the Statement of Standards for Continuing Professional Education (CPE) Programs, issued jointly by the AICPA and NASBA). Specifically, the pass rate percentage for our courses is 70%, our courses contain the required minimum number of quiz questions per CPE hour (5), and our courses contain the required minimum number of review questions per CPE hour (5).

A. INTRODUCTION AND DEFINITION OF PARTNERSHIP

Depending on the number of owners, a trade or business may be taxed as follows: (1) a sole proprietorship; (2) a regular C corporation; (3) an S Corporation; and, (4) a partnership. A limited liability company (LLC), while a separate entity for legal liability purposes, is not a separate entity for tax purposes. Under the check-the-box regulations, an LLC may be treated for tax purposes either as a corporation or partnership if there are two or more owners or as a sole proprietorship (disregarded entity) or corporation if there is only one owner.\(^1\) Taxpayers may elect their choice of taxation by filing Form 8832, "Entity Classification Election." If no election is made, under the default rules, the business will be treated as a partnership if there are two or more owners.\(^2\) Otherwise it will be treated as a sole proprietorship. Therefore, if an LLC is taxed as a partnership, the rules discussed in this course also apply to an LLC treated as a partnership for tax purposes.

By definition, a partnership includes a syndicate, group, pool, joint venture or other incorporated organization through which any business, financial operation or venture is carried on.\(^3\) If no formal partnership agreement exists between two or more parties, there may be some question as to whether there is a valid partnership. Perhaps it is a co-ownership of property rather than a partnership or perhaps an intended family partnership is not valid because an intended partner is not providing goods or services to the business venture.
The mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. However, tenants in common may be partners if they actively carry on a trade or business, financial operation, or venture and they divide profits. You might wonder what difference it makes as to whether a venture is treated as a partnership or co-ownership of property. The Podell case illustrates one major tax difference between partnerships and co-ownership – determining the character of income or loss from the sale of property. The taxpayer, who was an attorney and a real estate developer entered into an oral agreement whereby the taxpayer advanced money to be used for the renovation of real estate. The buildings on the property were renovated and sold and the profits from the sale were distributed equally. The issue was whether the profits should be treated as gain from property held primarily for resale (because of the real estate developer) or capital gain. If the arrangement is considered to be a co-ownership of property, the taxpayer would most likely have been able to report the profits as capital gain since he generally was not in the business of developing and selling property.

The IRS argued that a joint venture was established for the purpose of purchasing, renovating and selling real estate and that the gain should be ordinary income. The Tax Court stated that the elements of a joint venture include the following:

1. A contract showing an intent to form such a venture.
2. Agreement for the joint control of the property.
3. A contribution of money or services.
4. A sharing of profits but not necessarily losses.

The court noted that the primary distinction between a joint venture and a partnership was that the former is established for a single business venture. It indicated that elements 1, 3, and 4 were present. Therefore, it ruled that the property was owned by the joint venture and since the character of gain is determined at the partnership level, the gain is ordinary income.

**REVIEW QUESTIONS AND SOLUTIONS**

Questions

1. True or False. If no entity election is made by filing Frm 8832, a business with two or more owners will be taxed as a corporation.
Solutions

1. **False is the correct response.** If no entity election is made, a business with two or more owners will be taxed as a partnership.

**True is the incorrect response.** If no entity election is made, the default rules never treat the entity as a corporation. It will be treated for tax purposes as either a partnership (2 or more owners) or a sole proprietorship (1 owner).

A.1 Sole Proprietorship Versus Partnership

A partnership requires at least two taxpayers who contribute services, capital, or both to a trade or business and agree to share profits generated from the trade or business. A sole proprietorship is an unincorporated business owned by one individual. There have been instances where intended partnerships were not viewed as such in cases involving the following issues:

1. Family partnerships where the children were found not to represent bona fide partners, since they contributed neither services nor capital.
2. Agreements which were viewed more in the nature of an employer-employee relationship, whereby the employee was viewed as receiving compensation for services rather than a distributive share of partnership income.
3. Co-ownership of property where taxpayers were not considered to be actively involved in a trade or business.

In these situations, establishing the intent of sharing profits from a business is most crucial. In determining whether intent of operating a partnership existed, the courts have examined many factors. Some of the most important factors include:

1. Joint contribution of capital or services.
2. Joint ownership of the contributed capital.
4. Sharing of losses.
5. Exercise of control over the business.
6. The nature of the agreement and the parties’ conduct.
7. Representations to other parties that the taxpayers were partners of the business.
8. The holding of property by the partnership.
The validity of family partnerships is particularly difficult to establish if the partnership is primarily a service partnership. For example, if the partnership provides tax services, it generally would not be feasible to argue that the taxpayer's ten-year old daughter is a true partner. For capital intensive partnerships, a child may be deemed a true partner if the child transfers valuable consideration for a partnership interest. The consideration transferred could have been transferred to the child previously by gift as long as the gift was in fact complete. Nevertheless, other issues could arise such as whether the higher tax bracket family partners had been reasonably compensated by the partnership for services rendered to the partnership.

In determining whether a partnership, sole proprietorship, or employer/employee relationship exists, the courts have applied a facts and circumstances analysis. No one set of objective factors is determinative, but rather each case stands on its own set of individual factors. It is very important that the tax adviser carefully examine the agreement between the parties and establish the intent of the parties involved. If the taxpayer's intent is to establish a partnership, the drafting of a partnership agreement is very important.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

2. **Which one** of the following statements is false?

   a. According to the Tax Court, the sharing of profits is more critical than the sharing of losses in determining whether a joint venture exists.

   b. In determining whether a partnership or a co-ownership of property exists, establishing the intent of sharing profits is very important.

   c. A taxpayer must contribute both services and property to a partnership to be held a valid partner.

Solutions

2. "**C**" is the correct response. A valid partnership requires the contribution of property or services, not necessarily both.

   "**A**" is an incorrect response. In the Podell case discussed above, the Tax Court held that one of the factors of being a joint venture is the sharing of profits but not necessarily losses.

   "**B**" is an incorrect response. Merely sharing expenses will most likely be viewed as a co-ownership whereas sharing profits is one of the most important factors supporting a partnership.
A.2  Partnership Agreement

The partnership agreement is important beyond establishing the validity of the partnership. It also serves to spell out the implied agreements among the partners and to lessen misunderstandings in the future. Items that should be included in a partnership agreement include:

1. The profit, loss, and capital interests of the partners.
2. The services of each partner.
3. Voting power.
4. Voting requirements necessary to approve recommendations (simple majority, 60%, 2/3rds, etc.).
5. Retirement provisions.
6. Rights to sell, assign, or otherwise dispose of the partnership interest.
8. Allocations of pre-contribution gain and loss from partner contributions of property to the partnership.
9. Consequences in the event of the death of a partner.
10. Accounting elections such as depreciation methods, taxable year, and inventory methods.
11. Duration of agreement, particularly in joint ventures.
12. Capital contribution requirements.
15. "Outside" partner income (whether allowed, whether it must be shared with other partners).
17. Dissolution of partnership.

A.3  Electing Out of the Partnership Provisions

In many circumstances, co-owners of property could possess many of the attributes of a partnership. If the parties do not wish to operate in partnership form, they may be able to elect out of the partnership provisions. Congress authorizes the Treasury to exclude the following three types of organizations from partnership taxation if the taxpayer makes the proper election:
1. Investment purposes only and not for the active conduct of a business.

2. Organizations used for the purpose of joint production, extraction, or use of property, but not for the purpose of selling services or property extracted.

3. Dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.\(^5\)

The most common situation is the first one in which taxpayers are co-owners of investment property (for example a rental home) and they wish to avoid the uncertainty of being subject to the partnership tax provisions. Ironically, the election to be excluded from the partnership tax provisions must be made by the due date for filing the partnership tax return, including extensions. Thus, normally at least one partnership tax return must be filed. In certain situations, a return may not have to be filed.\(^6\) Where a return is filed, only the following information is required on the return:

1. Name and address of the organization.

2. Names and addresses of its members.

3. A statement that the organization is eligible for the exclusion and that all members of the organization agree to the election.

---

**TAX SAVER!!** There may be several tax-saving reasons why individuals would desire to elect out of the partnership tax provisions. For example, owners can make their own accounting elections such as depreciation (one may desire an accelerated method while another may prefer a smaller deduction in earlier years). Other reasons include (1) the character of property is determined at the owner level (capital gain versus the possibility of ordinary income at the partnership level), and (2) flexibility of selling the property (one can sell their interest and the other can retain their interest).

---

**REVIEW QUESTIONS AND SOLUTIONS**

Questions

3. Regarding the electing out of the partnership tax provisions, **which one** of the following statements is **true**?

   a. Generally, at least one partnership tax return must be filed.

   b. The due date of making the election is the first day of the organization’s taxable year.

   c. A tax professional business owned by three tax professionals may elect out of the partnership provisions.
Solutions

3. "A" is the correct response. Generally, a partnership return must be filed with the election to be excluded from the partnership provisions.

"B" is an incorrect response. The due date of making the election is the same due date for filing the partnership return, including extensions.

"C" is an incorrect response. Only three types of organizations are eligible to make the election. Generally, active trades or businesses may not elect out of the partnership provisions.

B. PARTNERSHIP FORMATION

B.1 Gain or Loss Recognition - General Rule

In general, there is no gain or loss recognized by the partner or partnership as a result of property transferred to a partnership in exchange for an interest in the partnership. This rule is contained in Section 721 of the Internal Revenue Code (IRC). Nonrecognition of gain does not apply if the partnership is treated as an investment company.7

The law does not specifically define an investment partnership. The law indicates that it has the same meaning as an investment corporation. A corporation is an investment company if immediately after the contribution of property to the corporation, greater than 80 percent of the corporate assets consists of assets (other than cash) held for investment and are readily marketable stock or securities.8

Example 1

Two medical doctors, Dr. Little and Dr. Lot, form Litlot Partnership. Little will have a 1/3 interest and Lot will have a 2/3 interest in the partnership. Little contributes $50,000 cash, while Lot contributes the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$20,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>20,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Office Building</td>
<td>60,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
<td>$55,000</td>
</tr>
</tbody>
</table>

Little's exchange of cash for a partnership interest is nontaxable. It would be equivalent to a shareholder purchasing $50,000 worth of stock with cash. Lot's contribution of property for a partnership interest also is nontaxable at the time of contribution.
Example 2

Assume the same facts as in Example 1, except that Lot's $100,000 worth of assets consists of the following:

<table>
<thead>
<tr>
<th>Stock Type</th>
<th>Value</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>100 Shares of XYZ Stock</td>
<td>$20,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>100 Shares of ABC Stock</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>200 Shares of LMN Stock</td>
<td>60,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$100,000</strong></td>
<td><strong>$55,000</strong></td>
</tr>
</tbody>
</table>

Little recognizes no gain or loss on the transaction. However, Lot would recognize $45,000 of gain because the partnership would be classified as an investment partnership (80% or more of its assets excluding cash are held for investment). Thus, Lot is treated as if he sold his stocks (with a $55,000 basis) to the partnership in exchange for a partnership interest valued at $100,000 (note that the value of Lot's partnership interest equals 2/3 of the $150,000 ($50,000 + $100,000) net value of the partnership).

**REVIEW QUESTIONS AND SOLUTIONS**

**Questions**

4. True or False. If a partner contributes appreciated property to a partnership considered to be an investment company in exchange for a partnership interest, the partner will recognize gain at the time of the contribution.

**Solutions**

4. **True is the correct response.** Generally, no gain or loss is recognized if a partner contributes property to a partnership in exchange for a partnership interest. This provision does not apply if the partnership is treated as an investment company.

**False is the incorrect response.** An investment company is where greater than 80 percent of the corporate assets consists of assets (other than cash) held for investment and are readily marketable stock or securities.

**B.2 Definition of Property**

The meaning of property is fairly broad. Property includes tangible property (machinery, buildings, automobiles, etc.), installment obligations, accounts receivable, and intangible assets. The primary item that is not included in the definition of property is services. For purposes of determining property, the taxpayer's method of accounting is not important. Refer back to Example 1.

Note that Partner Lot has a zero basis in the accounts receivable. Presumably Lot reported on the cash basis of accounting. If he were on the accrual basis of accounting, he would have recognized income on the receivables when the services were performed. The basis of the receivables would have equaled the amount of income recognized. The accounts receivable are considered to be
property, with or without basis. Although a cash basis partner does not recognize gain upon the transfer of accounts receivable to the partnership, the contributing partner will be allocated the income upon the collection by the partnership. The allocation of pre-contribution gain (such as with the cash-basis accounts receivable of Partner Lot in Example 1 above) or loss is discussed briefly in Section C.52 below.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

5. Which one of the following contributions to a partnership in exchange for a partnership interest will not qualify for gain nonrecognition at the time of contribution?

   b. Accounts receivable with a zero basis.
   c. Services to the partnership by the partner.

Solutions

5. "C" is the correct response. While the meaning of property under the nonrecognition provisions applicable to partnership contributions are broad, it does not extend to services.

   "A" is an incorrect response. Accounts receivable contributed to the partnership, whether the individual was on the accrual basis or cash basis of accounting, qualifies as property under this provision.

   "B" is an incorrect response. The definition of property includes intangible assets, such as a patent.

B.3 Contribution of Services - Unrestricted Partnership Interest

The Treasury regulations pertaining to IRC Section 721 (general rule for nonrecognition of gain) state that to the extent that any of the partners gives up any part of his right to be repaid his contributions in favor of another partner as compensation for services, IRC Section 721 does not apply. Thus, if a taxpayer provides services to a partnership in exchange for an unrestricted partnership interest in capital, profits, and losses, the taxpayer must recognize income. Liquidation values are used to determine the value of the service partner’s interest in the partnership. The regulations treat the value of the services rendered as a guaranteed payment. Generally, a guaranteed payment is deductible by the partnership. However, if the services are capital in nature, the amount treated as compensation by the service partner must be capitalized by the partnership.
Another issue with a partnership interest received for services is whether the partnership must report gain or loss from the partnership interest transfer. Proposed regulation 1.721-1(b)(1) states that no gain or loss is recognized by the partnership for the transfer of a partnership interest in exchange for services. The proposed regulations were issued in May 2005 and at the date of this writing they still are in proposed form. Consequently, there is considerable uncertainty as to whether a partnership must recognize gain or loss upon the transfer of a partnership interest in exchange for services rendered to the partnership. Many tax commentators have suggested that under the principles of the McDougal\textsuperscript{13} case, gain or loss should be recognized by the partnership.

In this case, the taxpayer purchased a race horse in 1968 for $10,000. He entered into an agreement with the horse trainer that after recovering his costs, one-half of the interest in the horse would be transferred to the trainer in exchange for the trainer's services, irrespective of the standard fee charged by the trainer. Later that year, he transferred a one-half interest at which time the value of the horse was $60,000. Thereafter, they agreed to share profits equally but the taxpayer assumed all losses. The taxpayer's tax return was amended to include the transfer as a $30,000 deduction for compensation and a $25,000 ($30,000 - (1/2 \times $10,000)) capital gain (originally treated as a gift).

In determining whether the arrangement was a partnership, the Tax Court defined a joint venture as one where:

1. Taxpayers engage in a specific enterprise.
2. There is pursuit of profit.
3. There are joint ownership of assets and profits.
4. There is a sharing of losses.
5. There is joint management.

The court concluded that all of the above attributes except number 4 were satisfied. As a result, the taxpayer was allowed capital gain treatment of $25,000 and a $30,000 compensation deduction. The horse trainer reported $30,000 of income and the basis in his partnership interest also was $30,000.

On the basis of this case and others that followed, when an individual provides services for an unrestricted partnership interest, the following transactions are deemed to occur:
1. The partnership transfers a proportionate interest in each partnership asset to the individual in exchange for the services rendered by the individual.

2. The individual recognizes ordinary income for the services rendered in an amount equal to the net value (assets less liabilities) of the assets received.

3. The partnership recognizes gain or loss from the hypothetical transfer of assets to the individual.

3. Immediately after the asset transfer, the individual contributes the assets received in step #2 for a capital interest in the partnership.

Based on the proposed regulations issued in May 2005, it seems unlikely that the IRS would require partnership gain or loss recognition from the capital interest transfer in exchange for services rendered to the partnership. However, until the proposed regulations are made final, the current tax treatment by the partnership for these types of transaction is uncertain.

Example 3

During the current year, Archy Teal provides architectural services relating to a new building under construction for the Realty Unlimited Partnership. In exchange, he receives a 10% interest in the partnership. The fair market value of the partnership assets is estimated to be $100,000. The partnership has no liabilities. Thus, the value of the partnership also is estimated to equal $100,000. Assume that the total basis of the partnership assets equals $80,000.

Assuming the principles prior to the proposed regulations apply, the following transactions are deemed to have taken place:

1. If the partnership were to liquidate today by selling its assets ($100,000) and paying its debts (none in this example), partner Archy Teal would be entitled to receive $10,000 (10% of $100,000). Thus, he must recognize $10,000 of income from the performance of services.

2. The partnership is treated as transferring 10% of its assets to Archy in return for the services. The partnership must recognize $2,000 of gain (10% * ($100,000 - $80,000)). This gain will be allocated to the nonservice partners at the end of the year.

3. Because the services rendered by Archy are capital in nature, the $10,000 compensation cost must be capitalized as a part of the cost of the building which is under construction.

4. The assets "transferred" to Archy (service partner) are deemed to be contributed back to the partnership by Archy. This hypothetical transfer is relevant in determining the basis of the partnership assets. See Section B.9 below.
Questions

BASE YOUR ANSWERS TO QUESTIONS 6 AND 7 ON THE FACTS PROVIDED BELOW

During the year, Tom Givens provides legal services which are noncapital in nature to a real estate partnership. Instead of receiving cash, he received a 20% unrestricted capital interest in the real estate partnership. At the time the interest was transferred, the fair market value and basis of the partnership assets were $200,000 and $150,000 respectively. Assume that the partnership has no debts.

6. What are the tax consequences to Tom as the result of the transfer?
   a. He must recognize $40,000 of ordinary income.
   b. He must recognize $40,000 of capital gain income.
   c. He does not have to recognize income because he is receiving a partnership interest instead of cash for his services rendered.

7. Assuming the proposed regulations do not apply, what are the tax consequences to the real estate partnership as the result of the transfer?
   a. It must recognize $50,000 of gain for the deemed transfer of property and it has a $40,000 deduction for the services rendered by Tom.
   b. It must recognize $10,000 of gain for the deemed transfer of property and it has an $8,000 deduction for the services rendered by Tom.
   c. It must recognize $10,000 of gain for the deemed transfer of property and it has a $40,000 deduction for the services rendered by Tom.

Solutions

6. "A" is the correct response. Since Tom provided services rather than property in exchange for his partnership interest, he must recognize income. Since he is being compensated for his services, the character of the income is ordinary income. The value of his services are based on the liquidation value of his partnership interest which is $40,000 in this case (20% x ($200,000 of assets less zero liabilities)).

"B" is an incorrect response. Since he is not transferring a capital asset for his partnership interest, the gain cannot be capital gain.

"C" is an incorrect response. Anytime property is received for services rendered including the receipt of a partnership interest, the service provider must report ordinary income.

7. "C" is the correct response. The partnership treats the services as a guaranteed payment. Since the services are not capital in nature, the partnership is allowed a deduction equal to the amount of income recognized by the service partner ($40,000 in his case). In addition, the partnership must recognize gain on the hypothetical transfer of property to the individual in exchange for the services. In this case, 20% of the assets are deemed to be transferred so the partnership must recognize $10,000 (20% x ($200,000 - $150,000)) of gain.
"A" is an incorrect response. Although there is $50,000 of appreciation on the total property held by the partnership, only 20% of the property was deemed to be transferred to the service partner so only 20% of the gain is recognized.

"B" is an incorrect response. The deduction is equal to the income recognized by the service partner, which is $40,000 in this case.

B.4 Contribution of Services - Restricted Partnership Interest

A restricted partnership interest may be transferred to the taxpayer providing services. Restrictions may exist concerning (1) the right to transfer the interest, (2) the right to participate in certain management decisions, such as negotiating new loans and contracts, and (3) forfeitures. Since the partnership interest is received in exchange for services (not property), the general rule of gain nonrecognition would not apply. Income would have to be recognized. However, two questions must be answered: (1) When must the income be recognized?; and, (2) What is the amount of the income?

IRC Section 721 indicates that the time when income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of the partnership interest. The amount of income recognized equals the fair market value of the partnership capital interest received as a result of the performance of services.

IRC Section 83, outside the specific partnership provisions of the Internal Revenue Code, covers all property transfers in connection with the performance of services. A typical application of this provision is in the area of stock options or restricted stock plans. Many executive compensation plans include the transfer of stock options or stock to executives after a condition, such as time of service, has been attained. Although IRC Section 721 specifically applies to partnerships, IRC Section 83 also applies.

Generally, under Section 83, income is recognized by the taxpayer performing the services in the first taxable year that the rights of the taxpayer having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture. Risk of forfeiture exists if the rights to full enjoyment of the property depend on the future performance of substantial services by the taxpayer. Transferability exists only if the rights in the property of any transferee are not
subject to a substantial risk of forfeiture. The value of the interest equals the fair market value of the property transferred less the amount paid (if any) for the property.

**Example 4**

On 1/1/10, Opey Rathman agrees to manage a partnership for a weekly salary. In addition, he receives a 10% restricted capital interest in the partnership. He may not sell or otherwise transfer this interest for two years. If Opey's services are deemed to be unsatisfactory, he may be released from employment at any time, and his partnership interest will be forfeited if he does not complete two full years of service. Assume that the values of the partnership on 1/1/10 and 1/1/12 were $100,000 and $300,000 respectively.

Because the transfer of the capital interest is contingent upon the completion of two years of services, only Opey's weekly salary will be included as compensation in his gross income during the first two years. When the restrictions lapse on 1/1/12, Opey will have to include an additional $30,000 (10% of $300,000) of compensation in his gross income.

The partnership may claim a $30,000 deduction, but in 2012 it must report gain attributable to the deemed transfer of $30,000 of assets.

If the transfer of the partnership interest in Example 4 were not subject to any restrictions, then Opey would have recognized only $10,000 of income in 2010.

Most taxpayers generally would rather defer the recognition of income as long as possible. However, no one can predict what the value of an interest will be in the future (two years in Opey's case in Example 4) and therefore, a taxpayer may prefer to report the income in the earlier year. IRC Section 83 permits the taxpayer to elect to include in his gross income the value of the interest at the time of transfer. The value of the interest at the time of transfer must be determined without regard to any restrictions, unless the restrictions never lapse.

If the partnership interest is expected to appreciate as it did in Example 4, the Section 83 election to include the value of the interest in income at the time it is received would provide two major advantages: (1) the appreciation in the partnership interest after the initial transfer generally would represent capital gain instead of ordinary income, and (2) the appreciation in the partnership interest after the initial transfer would not have to be recognized until the interest is sold.

If the taxpayer makes this election, he must notify the IRS no later than 30 days after the date the property was transferred to him. If the property is forfeited after the taxpayer had reported the value of transfer in his gross income, the forfeiture is treated as a sale or exchange. The basis of the
property would equal the amount of income reported as a result of the property transfer plus any amount paid for the property. However, the taxpayer may not recognize loss (although possibly he could recognize gain) as a result of the forfeiture. With respect to the partnership, IRC Section 83(h) indicates that the time of deduction by the employer (partnership) coincides with the year the income is reported by the person performing the services.

**TAX SAVER!!** Taxpayers who wish to take advantage of the IRC Section 83 election must be mindful of the 30-day time period. Many elections must be made by the due date of the tax return, but this election is 30 days after the property transfer.

Example 5

Refer to the facts of Example 4. Assume that Opey had elected to report the transfer of partnership interest as compensation in 2010. In 2011, he was fired and his interest was forfeited. In compliance with the partnership agreement, assume that the partnership paid him $4,000 upon the forfeiture.

In 2010, Opey would have reported $10,000 of income and his basis in the partnership interest would have equaled $10,000. Assume that there were no changes to the basis of the partnership interest up to the time of the forfeiture. Since he received $4,000 upon the forfeiture of his partnership interest, he would realize a $6,000 capital loss ($4,000 - $10,000) in 2011. However, the loss is not recognized under IRC Section 83(b)(2).

The partnership will claim a $10,000 deduction in 2010 as well as report any gain attributable to the deemed transfer of assets to the Opey (assuming the proposed regulations do not become permanent). In 2011, the partnership would be allowed to deduct an additional $4,000 assuming that the payment was pursuant to his compensation agreement with the partnership.

**TAX SAVER!!** If the taxpayer believes that the risk of forfeiture is relatively high, the election to include the services in the year the partnership interest is transferred is not advisable because no loss is deductible if the interest is forfeited.

**REVIEW QUESTIONS AND SOLUTIONS**

Questions

8. True or False. A taxpayer who elects to report a restricted partnership interest in the year the interest is received may not claim a loss deduction if the interest is subsequently forfeited.

9. Assume a taxpayer receives a restricted partnership interest on September 1 of the current year and would like to make the election to include the value of the interest in her income for the current year. By what date must she notify the IRS of the election?
a. October 1 of the current year.
b. December 31 of the current year.
c. April 15 of the next year.

10. On 1/1/10, John agrees to manage a partnership in exchange for a 10% restricted capital interest in the partnership. He may not sell or otherwise transfer this interest for two years. Assume that the values of John’s partnership interest on 1/1/10 and 1/1/12 were $200,000 and $300,000 respectively. If he elects to include the value of his interest in income when he receives the interest, how much is the partnership deduction and when is it reported by the partnership?

a. It may choose to deduct $20,000 in 2010 or $30,000 in 2012.
b. $20,000 deduction in 2010.
c. $30,000 deduction in 2012.

Solutions

8. **True is the correct response.** For unclear reasons, Section 83(b)(2) prohibits any loss deduction resulting from a forfeiture of a partnership interest. See Example 5.

**False is the incorrect response.** When the taxpayer elects to include the value of a restricted partnership interest in income in the year it is received, the basis of the interest is increased by the income recognition. Yet if the interest is forfeited, a loss deduction is not allowed.

9. "**A**" is the correct response. The taxpayer only has 30 days after receiving the restricted interest to notify the IRS that a Section 83(b) election will be made.

"**B**" is an incorrect response. December 31 of the current year would be correct if the taxpayer had until the end of the year to make the election.

"**C**" is an incorrect response. April 15 of the next year would be correct if the taxpayer had until the due date of the tax return to make the election. While this is the most logical date, it is not the allowed date.

10. "**B**" is the correct response. The partnership claims a deduction at the same time the service partner reports the value of the partnership interest in income. Since John reports $20,000 in income, the partnership is allowed a $20,000 deduction.

"**A**" is an incorrect response. The partnership may not choose when to report the deduction. It claims a deduction at the same time the service partner reports the value of the partnership interest in income.

"**C**" is an incorrect response. A $30,000 deduction in 2012 would be correct if John had not made the election to include the value of his interest in income when he received the interest.

B.5 Contribution of Services - In Exchange for a Profits Interest

The Treasury regulations indicate that to the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits)
in favor of another partner as compensation, the nonrecognition rules do not apply. For years, most tax "experts" believed that the parenthetical expression described above implied that a profits interest in exchange for services was not taxable to the partner until the profits were realized. However, in 1974, the Seventh Circuit held that a taxpayer receiving a profits interest had to include the value of the interest in income as compensation.

In this particular case, the partner had sold his partnership interest within three weeks of receiving it. Many commentators have argued that this case was unique and generally would not apply because most profits interests would not have a readily ascertainable fair market value at the time of transfer. Subsequently, very few cases have been heard on this issue and none had been decided against the taxpayer until the Campbell case in 1990.

In Campbell, the taxpayer was engaged in the formation and syndication of limited partnerships. Part of his "compensation" included nominal profits interests (1% to 2%) in the newly formed partnerships which had certain restrictions. In particular, his right to receive capital distributions were subordinated to the rights of the other partners. The Tax Court held that for the taxpayer to be taxed under IRC Section 83, the following three elements must be present:

1. The taxpayer must receive property (the court concluded that a profits interest constituted property).
2. The transfer must be in connection with services (the facts clearly indicated this).
3. The interest must be unrestricted.

The Tax Court went on to say that all three elements had been met and that the receipt of a special limited partnership interest was similar to the receipt of common stock which is subordinated to preferred stock in both dividends and liquidation proceeds. The court next valued the interest using discounted cash flow analysis. Interestingly, the court included the value of tax benefits received (from the allocation of losses) as part of the overall valuation.

In 1991, the Eighth Circuit reversed the Tax Court by holding that the profits interest was not taxable at the time of the transfer because it had no fair market value at that time. Unfortunately, it did not overrule the Tax Court on the basis of law, but rather concluded that the profits interest was not taxable because its subordinated nature to cash flow distributions made its valuation extremely
speculative. It left uncertain as to whether the receipt of a profits interest is generally taxable at the time of transfer.

The IRS in Revenue Procedure 93-24 provides a “safe harbor” in this area by stating that it will not treat the receipt of a profit interest in exchange for services as a taxable event unless one of the following three situations occur:

1. The profits 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;
2. The partner disposes of the profits interest within two years; or
3. The profits interest is a limited partnership interest in a publicly traded partnership.

Since this revenue procedure has been issued, there have been no court cases in this area. While the second and third situations are objective, situation number 1 is fairly subjective and in most situations the predictability of future cash flows are too uncertain to value a profits interest.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

11. If a taxpayer receives an unrestricted profits interest only in exchange for services rendered to the partnership, generally the taxpayer will not have to recognize income at the time of transfer primarily for what reason?

   a. The interest is so speculative that it will be valued at zero for tax purposes.
   b. It is not considered a taxable exchange.
   c. A profits interest is not considered property.

Solutions

11. "A" is the correct response. Because most businesses do not have a predictable stream of income, the value of a profits interest will be valued at zero. See the summary of the Eighth Circuit’s decision in Campbell above.

   "B" is an incorrect response. To the contrary, the Tax Court in Campbell ruled that a taxable exchange occurred.

   "C" is an incorrect response. Again, the Tax Court in Campbell ruled that a profits interest constituted property.

B.6 Property Transfers Encumbered By Debt

If the taxpayer transfers property encumbered by debt in exchange for a partnership interest,
gain results if the debt relieved from the contributing partner exceeds the basis of the total property transferred by the partner. All general partners (including the contributing partner) generally are responsible for partnership debts. If the creditor sued one of the partners for the entire amount of debt, that partner has subrogation rights. These rights give the partner the legal right to collect a portion of the claim against the other partners. That portion generally equals the partnership interests owned by the other partners.

Example 6

The ABCD partnership is owned equally by four Partners A, B, C, and D. The partnership is unable to satisfy its claims. One creditor collected a $10,000 partnership debt from Partner A. Since Partner A owns only a 25% interest in the partnership, he has the legal right to collect $7,500 of the debt payment from Partners B, C, and D.

For partnership property contributions, the partnership is considered to have assumed the liability to the extent of the property's fair market value. As Example 6 implies, if the partnership assumes a partner's debt, the entire amount of debt is not relieved since the partner still may be obligated to satisfy a portion of it. If, under state law, the partner who transfers the property to the partnership remains personally liable to the creditor and none of the partners bears any of the economic risk of loss for the liability under state law or otherwise, the transferor partner bears the economic risk of loss for the entire debt. Thus, the partner would not recognize any gain from the transfer and the net effect of the debt on the partner's basis in the partnership interest is zero.

On the other hand, state law provisions may hold the other partners personally liable on the debt. In such case, the contributing partner is relieved of a portion of the debt equal to the other partners' economic risk of loss. Although the rules for allocating partnership debt can be complicated (see Section D.3 below), for most general partnerships, a general partner's share of partnership debt is based on the partner's loss ratio. If under state law other partners are liable for debt transferred to the partnership by a partner, generally the debt relieved from the contributing partner is computed as follows:

\[
\text{Debt Relieved from Contributing Partner} = \frac{\text{Total Debt Assumed by the Partnership} * (100\% - \text{Contributing Partner's Interest in Losses})}{100}\]

19
Example 7

Larry transfers $2,000 cash and land valued at $23,000 for a 20% interest in the profits, losses, and capital of the ABC partnership. The land is encumbered by a $15,000 debt which is assumed by the partnership. Larry's basis in the land equals $6,000.

If none of the other partners is liable for the debt under state law, the debt relieved from Larry equals zero and the basis of his partnership interest equals $8,000 ($2,000 + $6,000).

On the other hand, if all of the partners share in the economic risk of loss of the debt, the debt relieved from Larry equals $12,000 ($15,000 x (100% - 20%)). Since the total basis of the property transferred only equals $8,000 ($2,000 + $6,000), Larry must recognize $4,000 of gain from the property transfer.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

12. Partner A transfers $1,000 cash and land valued at $30,000 for a 40% interest in the profits, losses, and capital of the ABC Partnership. The land is encumbered by a $25,000 debt which is assumed by the partnership. Under state law, all partners share in the economic risk of loss of the debt. Partner A's basis in the land equals $13,000. As a result of the transfer, Partner A must recognize gain of:

a. $11,000.
b. $ 2,000.
c. $ 1,000.

Solutions

12. "C" is the correct response. Gain is recognized to the extent that the debt relieved of $15,000 (60% x $25,000) exceeds the $14,000 ($13,000 + $1,000) total basis of property transferred. Thus, $1,000 of gain is recognized.

"A" is an incorrect response. $11,000 would be correct of the entire debt of $25,000 would have been relieved. However, he is still responsible for 40% of the debt.

"B" is an incorrect response. $2,000 would be correct if the basis only included the property which is encumbered by the debt. In this case, his basis is also increased by the $1,000 cash contribution.

B.7 Property Sales Versus Property Transfers

If a partnership cash distribution is made to a partner after the partner contributes property to the partnership, the transaction may be viewed as a sale. For many years, Treasury regulations pertaining to partnership cash distributions (IRC Section 731) have provided the following guidance:

If there is a contribution of property to a partnership and within a short period either (1) before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or (2) after such
contribution the contributed property is distributed to another partner, such distributions may not fall within the scope of Section 731.27

Despite this regulation, the court decisions generally had favored the taxpayer with respect to a transaction which in substance was a sale, but in form, was a contribution followed by a distribution to the partner.28 In response to court decisions in this area, Congress amended the Internal Revenue Code by adopting a provision similar in language to the above regulation. Basically, it indicates that if the property contribution to the partnership and the property distribution to the partner are more properly characterized as a sale or exchange of property, the contribution/distribution will be treated as such.29

The Treasury issued regulations which describe situations in which certain partner transfers to the partnership are treated as a sale of property by the partner to the partnership. In cases where a transfer of property by a partner to a partnership is connected with a transfer of money or other consideration to the partner, the transfer will be characterized as a sale if the facts and circumstances indicate that (1) the transfer of money or other consideration to the partner would not have been made but for the transfer of property to the partnership; and (2) in cases where the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.30

Example 8

Billy and Bob formed the BILLY BOB partnership. Billy contributed land valued at $60,000 and machinery valued at $30,000 for a 50% interest in the partnership. Bob contributed $60,000 of cash for a 50% interest in the partnership. Immediately after the partnership formation, the partnership distributed $30,000 cash to Billy.

Based on the above facts, it appears that the IRS would have a strong case in arguing that the contribution of the machinery should be recast as a sale of the machinery (or a portion of the land and machinery) to the partnership. It would be difficult to argue that, immediately after the sale, the partners intended to have an equal interest when one partner contributed $90,000 of property and the other partner contributed $60,000 of property. Under the two-year presumptive rule discussed below, the regulations treat part of the transfer in this example, as a sale.

The Treasury provides 10 factors which give evidence of a sale versus a contribution. Most of the factors focus on whether there is a partnership obligation to make a distribution following the contribution and whether there is a pre-arranged agreement to fund the distribution. The factors are summarized below:
1. The timing and amount of subsequent distribution are determinable at the time of the earlier transfer.

2. The subsequent transfer is legally enforceable.

3. The subsequent transfer is secured.

4. A person is legally obligated to make contributions to fund the transfer.

5. A person has loaned money to the partnership to effect the transfer.

6. The partnership is obligated to acquire a loan to effect transfer.

7. The partnership holds money in liquid assets beyond the reasonable needs of the business to be available for the transfer.

8. Partnership distributions, allocations, or control effectively shift the burdens and benefits as to effectively make the transfer.

9. The transfer of money to the partner is disproportionately large.

10. A partner is not obligated to repay the distribution.\(^\text{31}\)

If within a two-year period from the time a partner transfers property to a partnership, the partnership transfers money or other consideration to the partner, the transfers are presumed to be a sale unless the facts clearly establish otherwise.\(^\text{32}\) Transfers falling under the two-year presumption rule must be disclosed to the IRS if the partner does not treat the transfers as a sale and the transfer of money is not presumed to be either (1) a guaranteed payment, (2) a reasonable preferred return, or (3) an operating cash flow distribution.\(^\text{33}\) Disclosure of the transaction must be reported on Form 8275.

In the event that the cash or property received by the partner is less than the value of the property transferred to the partnership, part of the transfer will be treated as a sale and the other part will be considered a nontaxable contribution. The basis of the property is allocated between the two portions according to the relative values of each portion.\(^\text{34}\) The basis of the property in the hands of the partnership equals the basis of the “contributed” portion plus the fair market value of the “sold/purchased” portion.

**Example 9**

Partner A transfers property X to the ABC partnership. The property is valued at $4,000 and its basis is $1,200. Immediately after the transfer, $3,000 is distributed to Partner A.
Under the Section 707 regulations, Partner A is considered to have sold a portion of property X with a value of $3,000 to the ABC partnership and to have contributed $1,000 to the partnership in A's capacity as a partner. $900 of basis ($3,000/$4,000 x $1,200) is allocated to the sale resulting in a recognized gain of $2,100 ($3,000 - $900).

The basis of the property in the hands of the partnership equals $3,300 ($300 of basis for the contributed portion ($1,000/$4,000 x $1,200) and $3,000 for the purchase portion. One way to verify this computation is to subtract any unrecognized gain remaining in the property from the property’s fair market value. In this case, the unrecognized gain is $700 (original gain realized of $2,800 - the $2,100 gain recognized) resulting in a basis of $3,300 ($4,000 - $700).

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

13. If a partnership cash distribution is made to a partner after the partner contributes property to the partnership, the transaction may be viewed as a sale. The Treasury provides that if the cash distribution follows the property contribution within a specified period, the transfer is presumed to be a sale unless the facts clearly establish otherwise. How long is this specified period?
   
   a. 6 months.
   b. 12 months.
   c. 24 months.

Solutions

13. **"C" is the correct response.** The regulations provide that if a distribution to a partner is made within two years of a partner’s property contribution, the distribution is presumed to be a sale unless the facts clearly establish otherwise.

   **"A" is an incorrect response.** Even if the Treasury had not provided a set time period, generally six months is not considered long enough to preclude the application of the “step transaction doctrine.”

   **"B" is an incorrect response.** In many areas of tax law, an event one year after a preceding event is considered to be sufficiently “old and cold” to invoke the “step transaction doctrine.” Nevertheless, the Treasury in this case presumes distributions within two years from the contribution will be considered a sale of the property.

B.8 Organizational Expenses

Before the actual formation of a partnership, the prospective partners are likely to incur expenses associated with the creation of the partnership. Since the expenses are incurred before the formation of the partnership, they do not qualify as ordinary and necessary business expenses of the partnership. Congress provides that taxpayers may **elect** to amortize qualifying organizational expenses over 15 years beginning with the month in which the entity begins business. The first
$5,000 of organizational expenditures is deductible in full in the tax year that the business begins. If the organizational expenditures are more than $50,000, the $5,000 amount is reduced dollar for dollar by the amount of the expenditures over $50,000. The election is irrevocable and the amortization period may not be changed. If the election is not made, the expenses may not be amortized.

Organizational expenditures are defined as expenses which are (1) incident to the creation of the partnership, (2) capital in nature, and (3) expected to benefit the partnership throughout its entire life. Thus, expenses must be for creating the partnership and not for selling partnership interests or for starting up the operations of the partnership's trade or business. Examples of organizational expenditures include:

1. Legal fees for services incident to the organization of the partnership, such as fees for negotiation and preparation of the partnership agreement.
2. Accounting fees for services incident to the organization of the partnership, such as amounts paid for tax advice.
3. Filing fees.

Examples of expenses which are not considered organizational expenses are:

1. Expenses connected with acquiring assets for the partnership or transferring assets to the partnership.
2. Expenses connected with the admission or removal of partners other than at the time the partnership first is organized.
3. Syndication expenses.

The organizational expenses must be incurred during the period beginning at a point which is reasonable in time before the partnership begins business, and ending on the date the first partnership tax return is due (not including extensions). The Treasury regulations state that ordinarily a partnership begins business when it starts the business operations for which it was organized. The acquisition of operating assets is normally sufficient. However, the mere signing of the partnership agreement is not sufficient to establish the beginning of the business.

Example 10

On July 1, 2011, the Newy Partnership began business. A December 31, taxable year end was chosen and the accrual basis of accounting was adopted. The following expenses were incurred during the period May 1, 2011 - June 30, 2012:
5/10/11        Accounting Fees - Tax Advice  $5,000  
    In Establishing Proper Entity
9/10/11        Accounting Fees - Preparing Prospectus  2,400
12/1/11        Filing fees  600
2/10/12        Legal Fees - Partnership Agreement  3,000
5/1/12         Other Filing Fees  300

The expenditures on 5/10, 12/1, and 2/10 qualify for organizational expenses. They total $8,600. The 9/10/11 expenditure does not qualify since it constitutes an expense of selling partnership interests. The 5/1/12 expenditure does not qualify because it was incurred after the due date of the first partnership tax return (4/15/12). The deduction for organizational expenditures for 2011 equals $5,120 ($5,000 + $120 ($3,600/180 months x 6 months)). For 2012, the deduction equals $240 ($3,600/180 months x 12 months).

If the partnership had adopted a cash basis of accounting, the expenditure incurred on 2/10 would not be deductible until 2012.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

14. On September 1, 2011, the ABC Partnership began its business. A December 31, taxable year end was chosen and the accrual basis of accounting was adopted. The following expenses were incurred during the period 7/1/11 - 4/30/12:

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/10/11</td>
<td>Legal Fees - Choosing Entity</td>
<td>$5,000</td>
</tr>
<tr>
<td>9/10/11</td>
<td>Broker Fees - Selling Partnership Interests</td>
<td>1,800</td>
</tr>
<tr>
<td>12/21/11</td>
<td>Filing fees</td>
<td>3,600</td>
</tr>
<tr>
<td>1/05/12</td>
<td>Legal Fees - Partnership Agreement</td>
<td>5,400</td>
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<tr>
<td>4/18/12</td>
<td>Legal Fees - Amendments to the Partnership Agreement</td>
<td>2,400</td>
</tr>
</tbody>
</table>

What is the maximum amortization deduction for 2011?

a.  $ 5,080.
b.  $ 5,200.
c.  $14,000.

Solutions

14. "B" is the correct response. Only the 7/10, 12/21/ and 1/5 expenditures qualify for the deduction. This totals $14,000. The deduction for 2011 is $5,000 of immediate expense plus $200 ($9,000 /180 months x 4 months).

"A" is an incorrect response. 5,080. Would be correct if the 1/5 expenditure did not count in 2011 because the partnership reported on the cash basis. In this case, the $5,400 would be amortized beginning in 2012.

"C" is an incorrect response. $14,000 would be correct if all of the organization expenses could be deductible in full in the first year.
B.9 Basis Computations Immediately After Formation

There are two basis calculations that are required after the formation of a partnership. First, the basis of each partner's interest in the partnership must be computed. Second, the partnership's basis in the contributed assets must be computed. The basis of a partner's interest in the partnership often is referred to as "outside basis," that is, the basis outside the partnership. The partnership's basis in assets which it owns often is referred to as "inside basis." For most smaller general partnerships, the sum of the outside bases equals the sum of the inside bases. This, however, may not be true if the partnership has not elected IRC Section 754 (discussed in the course “Partnership Taxation – Part II”).

A partner's initial basis is computed as follows:

\[
\text{(A) Cash Contributed to the Partnership} \\
\text{(B) + Basis of other Property contributed to the Partnership} \\
\text{(C) + Income Recognized by the Partner Rendering Services In Exchange} \\
\text{for a Partnership Interest} \\
\text{(D) + Gain Recognized by the Partner if the Partnership Qualifies} \\
\text{as an Investment Partnership} \\
\text{(E) + Liabilities Assumed by the Partner} \\
\text{(F) - Liabilities Relieved from the Partner} \\
\]

Basis of the Partner's Interest in the Partnership

If a partner contributes capital assets or Section 1231 assets for his partnership interest, the holding period of those assets tacks on to his partnership interest. If other assets are contributed, the holding period for the partner's partnership interest begins at the date of contribution.

In most cases, the partnership's basis in the assets transferred to the partnership is straightforward. It equals the contributing partner's basis in the property immediately before the transfer of the property to the partnership. This is called a "carryover basis." In addition, for purposes of calculating the partnership's holding period for property, the length of time that the property was held by the partner is included in the partnership's holding period for the property.

Example 11

This example uses the facts of Example 1, where the two medical doctors, Dr. Little and Dr. Lot, form a general partnership to which Partner Little contributes $50,000 cash, while Partner Lot contributes $100,000 of assets as follows:
<table>
<thead>
<tr>
<th></th>
<th>Value</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$20,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>20,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Office Building</td>
<td>60,000</td>
<td>40,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$100,000</strong></td>
<td><strong>$55,000</strong></td>
</tr>
</tbody>
</table>

Applying the above formula, Partner Little's basis in the partnership equals $50,000 (component (A) of the basis formula). Partner Lot's basis in the partnership equals $55,000 (component (B) of the basis formula). The partnership's basis in the assets equals $15,000 for the equipment, -0- for the accounts receivable, $40,000 for the office building, and $50,000 for the cash. Note that the sum of the partners' outside bases ($50,000 + $55,000) equals the sum of the partnership's inside basis in the contributed properties ($50,000 + $15,000 + $0 + $40,000).

Where a service partner receives a capital interest in the partnership, the partnership basis calculations are a little more complicated. As discussed above in Section B.3, assuming the proposed regulations do not become finalized, the partnership is deemed to have transferred a proportionate share of each partnership asset to the service partner. In turn, the service partner is deemed to contribute the assets received back to the partnership in exchange for a partnership interest. Since the partnership recognizes gain or loss on the deemed transfer of the assets, the basis of the portion of partnership assets deemed transferred to the service partner and recontributed to the partnership is adjusted to reflect the fair market value at the date of transfer. The amount of the adjustment equals the gain or loss recognized by the partnership from the deemed transfer. For example, if the partnership recognized gain, the basis of the assets recontributed is increased by the gain. If a loss were recognized, the basis of the assets is reduced by the loss.

**Example 12**

The ABCD partnership is engaged in real estate and owned equally by partner’s A, B, C, and D. Individual E provides legal services to the partnership in exchange for a 20% unrestricted capital interest. At the time of transfer, the partnership assets have a value of $1,000,000 and a basis of $800,000. Assume there are no partnership debts. Each original partner has a basis in the partnership interest (outside basis) of $200,000.

Because Partner E receives an unrestricted capital interest, he must recognize income to the extent of the value of capital transferred to him, or a total of $200,000 ($1,000,000 x 20%). E’s basis in the partnership also equals $200,000 (component C of the basis formula). If the services rendered by E are ordinary and necessary expenses, the partnership will be allowed a deduction. This deduction must be allocated to the nonservice partners (A, B, C, and D).
The partnership is treated as transferring 20% of the partnership property to Rocky in exchange for his services. Thus, the partnership must recognize $40,000 (($1,000,000 - $800,000) x 20%) of gain on the deemed transfer of assets.

As a result of the above transfer, the partnership’s assets will have a basis of $840,000. This can be calculated two ways. First, it equals the basis of the assets “retained” by the partnership after the hypothetical transfer of assets to E (which is 80% of the total basis of the assets or $640,000) plus the basis of the assets deemed to be transferred to E and contributed by E to the partnership for a 20% partnership interest (which equals 20% of the value of the assets which equals $200,000). Second, the $840,000 equals the original basis of $800,000 plus the $40,000 of gain recognized by the partnership.

With respect to the partners’ outside bases, Partner E has a basis of $200,000 and partner’s A-D have a combined basis of $800,000 for a grand total of $1,000,000. This results in a difference between the outside and inside basis of $160,000 ($1,000,000 - $840,000). This difference will be eliminated at the end of the year when Partner’s A - D collectively will increase their outside bases by the $40,000 partnership gain and reduce their bases by the $200,000 guaranteed payment deduction.

All general partners are responsible for any debt assumed by the partnership to the extent that they are at risk for payment in the event that the partnership assets are not sufficient to repay the debt (Section B.6 above). A partner's assumption of a partnership liability is treated as if the partner made a cash capital contribution to the partnership. Thus, the partner's basis is increased by his pro rata share of partnership liabilities. Similarly, his basis is increased by any increase in a partner's individual liabilities by reason of his assumption of partnership liabilities. For most partnerships, it is assumed that each general partner shares in partnership debt in proportion to the partner's interest in losses. Conversely, a reduction in a partner's share of partnership liabilities, or any decrease in a partner's individual liabilities because the partnership assumes the liability, is considered a cash distribution. Thus, the basis of a partner's interest is decreased by the deemed cash distribution. A more detailed discussion of partnership debts and their affect on partners’ outside bases is discussed in Section D.3 below.

Example 13

Bill and Larry form the BL Partnership. Bill contributes $100,000 cash. Larry contributes land worth $200,000. It has a basis of $125,000 and it is encumbered by a $50,000 mortgage which the partnership assumes. Bill has a 40% interest and Larry has a 60% interest in the partnership.

Larry's basis of $100,000 is increased by his pro rata share of liabilities assumed by the partnership. Thus, his basis is increased by $20,000 ($50,000 x 40%)
to $120,000. Larry's basis reduction of $20,000 can be arrived at in one of two ways. First, the transaction can be looked at as if the partner fully reduced his individual liability of $50,000 and increased his share of partnership liabilities by $30,000 ($50,000 x 60%). Thus, he would reduce his basis by $50,000 and increase his basis by $30,000. Second, one can look at the net effect. Applying the concepts of Section B.6 above, Larry has been relieved of $20,000 ($50,000 x (100% - 60%)) of liabilities as a result of the contribution of encumbered property thus reducing his outside basis to $105,000.

The total outside bases equals $225,000 ($120,000 + $105,000). The partnership's inside basis also equals $225,000 ($100,000 cash and $125,000 basis in the land).

** REVIEW QUESTIONS AND SOLUTIONS ** (Based on Sections B.1 – B.9).

Questions

Review Question 15 - 18 are based on many of the concepts discussed in Section B and are based on the following information:

Daisy, Donald, Mickey and Minnie form the Double DM Partnership. Each receives a 25% interest for his/her contribution. Their contributions are as follows:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Description</th>
<th>Value</th>
<th>Basis</th>
<th>Debt Transferred</th>
<th>Net Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Daisy</td>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>Donald</td>
<td>Land</td>
<td>$32,000</td>
<td>$24,000</td>
<td>$12,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Mickey</td>
<td>Equipment</td>
<td>$20,000</td>
<td>$24,000</td>
<td></td>
<td>$20,000</td>
</tr>
<tr>
<td>Minnie</td>
<td>Services</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

All partners are considered to share equally in the economic risk of loss of the assumed debt. In return for a 25% unrestricted interest in the partnership, Minnie agrees to operate the partnership for the first year without compensation.

15. What is the net gain or loss recognized by Mickey and Minnie as a result of the partnership formation?

   a. Mickey – $4,000 loss; Minnie $15,000.
   b. Mickey – no gain or loss; Minnie $20,000.
   c. Mickey – no gain or loss; Minnie $15,000.

16. What is the net gain or loss recognized by the partnership as a result of the partnership formation assuming the proposed regulations do not apply?

   a. $2,000.
   b. $1,000.
   c. $4,000.
17. What are the bases of the Donald’s and Minnie’s partnership interests immediately after the partnership formation?

a. Donald – $15,000; Minnie – $18,000.
b. Donald – $24,000; Minnie – $15,000.
c. Donald – $23,000; Minnie – $18,000.

18. What are the bases of the land and equipment immediately after the partnership formation?

a. Land – $24,000; Equipment – $24,000.
b. Land – $32,000; Equipment – $20,000.
c. Land – $26,000; Equipment – $23,000.

Solutions

15. "C" is the correct response. Mickey transferred depreciated property to the partnership. However, the nonrecognition provisions applicable to partnership contributions applies to losses as well as gains. While he has a $4,000 loss realized, his recognized loss is zero. Since Minnie’s contribution of services is not covered under the general nonrecognition provision, the first step is to compute the value of her compensation based on liquidation values. The value of the partnership assets equals $72,000 ($20,000 cash + $32,000 land + $20,000 equipment). Since the partnership assumed a $12,000 liability, the net worth of the partnership equals $60,000. Because Minnie now has a 25% interest in the partnership's capital, the value of her capital account and thus the amount of her compensation is $15,000 (25% x $60,000). Thus, she recognizes $15,000 of income.

"A" is an incorrect response. Under the nonrecognition provisions applicable to partnership contributions, Mickey’s $4,000 realized loss on the transfer is not recognized.

"B" is an incorrect response. Since the net value of each of the other three partner’s contribution is $20,000, Minnie’s services must be worth $20,000. However, liquidation values are used to value her services. If the partnership sold its assets for fair market value, paid its debts, and distributed the proceeds equally, she would receive $15,000, not $20,000.

16. "B" is the correct response. Under general principles of partnership taxation, the partnership must recognize gain or loss to the extent of the assets deemed transferred to an individual in exchange for the performance of services. In this case, 25% of the cash, land, and equipment is deemed to be transferred to Minnie. As a result, the partnership recognizes $2,000 (25% x $8,000) of gain on the land and $1,000 (25% x $4,000) of loss on the equipment for a net gain of $1,000.

"A" is an incorrect response. $2,000 would be correct if gains were recognized but not losses from the deemed asset transfer for the service.

"C" is an incorrect response. $0 would be correct if the proposed regulations in their current form became final regulations.

17. "A" is the correct response. Because all partners are considered to share equally in the economic risk of loss of the assumed debt, Donald is relieved of $9,000 (75% x $12,000) of debt. Using the basis formula explained in Section B.9 above, the basis in his partnership interest is increased by the $24,000 basis in the land (component B of the formula) and reduced by the $9,000 of liabilities relieved (component F). First, Minnie’s basis is increased by the $15,000 income recognized for her services (component C). Second, because Minnie
is a 25% partner, her basis is also increased by $3,000 (25% x $12,000) of liabilities assumed by the partner (component E).

"B" is an incorrect response. If Donald’s property had no debt, the bases of Donald and Minnie would be $24,000, and $15,000, respectively as explained in Response A.

"C" is an incorrect response. This response would be correct if Donald’s basis were increased by the fair market value rather than the basis of the land contributed to the partnership.

18. "C" is the correct response. Generally, the partnership's basis in the assets equals the partner's basis in the assets transferred. This equals $68,000 ($20,000 + $24,000 + $24,000). However, because 25% of the partnership assets were deemed transferred to the service partner Minnie and recontributed to the partnership, an adjustment must be made to the assets "recontributed" to the partnership. In this case, the basis of the land is increased by the $2,000 gain recognized by the partnership and the basis of the equipment is reduced by the $1,000 loss recognized by the partnership from the deemed transfers. Thus, the adjusted bases of the land and equipment are $26,000 ($24,000 + $2,000) and $23,000 ($24,000 - $1,000).

"A" is an incorrect response. This response would be correct if the proposed regulations became final regulations as no gain or loss would be recognized by the partnership.

"B" is an incorrect response. This response would be correct if the basis of the assets in the hands of the partnership were based on fair market value rather than basis at the time of transfer.

C. PARTNERSHIP OPERATIONS

C.1 General Concepts

Partnership taxation reflects elements of both the entity and aggregate concepts. The entity concept treats the business as a separate entity distinct from its owners. For example, most elections, such as taxable year, depreciation method, and inventory methods, are made by the partnership.

The aggregate concept treats the partnership as a conduit, whereby each partner is treated as owning an interest in the various components of the business as opposed to the partnership interest itself. For example, each partner, not the partnership, pays income taxes on his pro rata share of income. Another example is that for certain sales of a partnership interest, the sale is treated as a sale of the partner's interest in the partnership assets rather than a sale of the partner's interest in the partnership (which is an intangible asset such as common stock). The application of the aggregate concept generally has been the cause for increased complexity in the taxation of partnerships, particularly in the areas of (1) allocations of income, (2) sales of partnership interests, and (3) partnership distributions.
C.2 Reporting of Income, Gain, Loss, Deductions, & Credits

A partnership is not subject to federal income taxation. Instead, each partner is responsible for reporting his share of partnership income, gain, loss, deduction and credit. This requirement is accomplished by calculating the total partnership taxable income or loss as if it were a separate tax-paying entity, and then allocating the taxable income or loss to the various partners according to their distributive shares of such items.

Partnership items which could affect a partner's tax liability if the item were reported separately must be accounted for separately. This requirement is an application of the aggregate concept. That is, the character of the item is retained and passed on to the individual partner as if the partner had earned or incurred the item directly. The IRC identifies six items for which separate reporting is required:

1. Short-term capital gains and losses.
2. Long-term capital gains and losses.
3. Trade or business gains and losses.
4. Charitable contributions.
5. Dividends distributed to corporate partners which are eligible for the dividends received deduction.
6. Foreign taxes paid or accrued.

The Treasury has the authority to provide a list of other items which require separate reporting. Items not requiring separate reporting are lumped together as ordinary business income (loss). The "ordinary" term is a little misleading since often it is used in contrast to capital gain. There are several "ordinary" type items which require separate reporting, such as interest income and rental income. The more common items which require separate reporting include the following:

1. Income or loss from real estate rental activities.
2. Income or loss from other rental activities.
3. Portfolio income such as interest and dividend income.
4. Guaranteed payments.
5. Immediate expense deduction (IRC Section 179).
6. Intangible drilling and development costs.

Again, the reason for the separate reporting is that each partner’s unique circumstances dictate what effect the items will have on the partner’s tax liability. Each one of the above items has a limitation (for example, the deductibility of capital losses and charitable contributions are limited), exclusion, or other special treatment (for example, trade or business losses may be treated as ordinary deductions or capital losses depending on the circumstances). Because the partnership pays no income tax, all tax credits earned by the partnership are separately reported by allocating the credits to each partner on the basis of the partner’s partnership interest.

Example 14

Three Partners, A Corporation, B, and C, each owns a 1/3 interest in the CII Partnership. For the current year, CII's taxable income is $105,000. Included in the taxable income calculation is a $15,000 long-term capital loss. A is a regular C Corporation which realized no capital gains or losses during the year. B is an individual who realized a $5,000 capital gain from the sale of common stocks. C is an individual who had no other capital asset transactions during the year.

If the law simply required the partners to report their distributive share of taxable income of the partnership, each partner would have reported $35,000 of income ($105,000/3) from the partnership. However, the law requires the separate reporting of capital losses. Thus, the $15,000 capital loss item must be removed from the taxable income calculation. Accordingly, each partner must report $40,000 ($120,000/3) of ordinary business income and $5,000 ($15,000/3) of capital loss.

Although the separate reporting of a $40,000 positive item and a $5,000 negative item results in a net effect of $35,000, the capital loss limitation affects each of the 3 partners differently. Since corporations only may deduct capital losses against capital gains, A is prohibited from deducting the capital loss this year against its corporate taxable income. B may net his $5,000 capital loss against his personal capital gain. Since only $3,000 of capital losses are allowed by individuals each year, C may only deduct $3,000 of the $5,000 partnership capital loss allocated to him. The other $2,000 capital loss may be carried forward indefinitely to future taxable years.

Form 1065 (available at www.irs.gov) is used to report the results of partnership activities. It may help to download Form 1065 and Schedule K-1 when reviewing this section. The first page of Form 1065 is similar to Form 1040 for individuals and Form 1120 for corporations. It contains the usual taxpayer identification information as well as a list of administrative questions. The remainder of the page consists of the summary of "ordinary" income and deduction items which nets to ordinary business income. The items which require separate accounting are reported on Schedule K (page 4 of Form 1065). Note that guaranteed payments require separate reporting on Line 4 of
Schedule K even though they are deductible on Line 10 of Form 1065 in arriving at the partnership's ordinary business income. This schedule also is used to report tax preference items which may affect a partner's alternative minimum tax calculation.

Schedule K-1 is used to report each partner's distributive share of partnership items. Each item reported on Schedule K also is reported on Schedule K-1. Note that, for individuals, the second page of Schedule K-1 indicates where the particular items should be reported on the partner's Form 1040.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

19. Which one of the following items is both separately stated on Schedule K-1 and included in the computation of ordinary business income reported on Form 1065?

   a. Rent Expense.
   b. Guaranteed Payments.
   c. Interest Income.

Solutions

19. "B" is the correct response. Guaranteed payments are both deducted as an expense in computing ordinary business income (line 10 of page 1 of Form 1065) and reported on line 4 of Schedule K (page 4 of Form 1065).

"A" is an incorrect response. Rent expense is deducted as an expense in computing ordinary business income. However, it is not reported as separate item on Schedule K.

"C" is an incorrect response. Interest income is reported as a separate item on Schedule K. However, it is not reported on page 1 of Form 1065 in computing ordinary business income.

C.3 Character of Partnership Items

Generally, the character of any item of income, gain, loss, deduction, or credit is determined at the partnership level (the entity concept). Thus, if the partnership sells an asset which is considered a capital asset in its hands, the character (capital gain or loss) is preserved when it is allocated to each partner. The following three types of property contributed by the partner to the partnership are an exception to the general rule:

1. Unrealized Receivables.
2. Inventory Items.
3. Capital Loss Property.
If any of the preceding properties is contributed by a partner, the character of the gain or loss realized by the partnership is determined by examining the character of the property immediately before the contribution to the partnership. The purpose of this provision is to prevent the conversion of one type of income or loss to a type of income or loss which receives more favorable tax treatment. If the partnership retains inventory items or capital loss property for at least five years, the exception does not apply. For capital loss property, the capital loss determined at the partner level applies only to the built-in loss at the time of the contribution. The character of any post-contribution loss is determined at the partner level.

Example 15

In Year 1, Sheila contributes land to a partnership. She owns a 25% interest in the partnership. At the time of the contribution, the land was worth $10,000 and it had a $22,000 basis. Sheila held the land for investment for several years. The partnership's primary business is the sale of realty property.

Assume that in Year 2, the partnership sells the land contributed by Sheila for $12,000. The carryover basis rules apply to partnership property contributions. Thus, the partnership's basis in the land is $22,000 and the partnership realizes a $10,000 loss which will be allocated in full to Sheila (See Section C.52 below for a discussion of allocating built-in gains and losses from contributed property). Because the partnership's primary business is the sale of land, normally the loss realized from the sale would be classified as an ordinary loss. However, since the land was capital loss property when it was contributed to the partnership by Sheila, the sale must be reported as a capital loss rather than as an ordinary loss.

If the land were sold for $8,000 rather than $12,000, the character of the post-contribution loss of $2,000 ($10,000 - $8,000) is determined at the partnership level. If the land is considered inventory in the hands of the partnership, $2,000 of the $14,000 loss is treated as an ordinary loss and the $12,000 built-in loss is treated as a capital loss.

For purposes of this exception, the definition of capital loss property is the same as in other areas of the law. The meaning of the other two property categories is not as straightforward. Unrealized receivables typically are trade accounts receivable which have not been included in income previously under the partner's method of accounting. For example, a partner who contributes trade accounts receivable to a partnership will not have recognized income from the receivables if he reports on the cash basis of accounting. Under the general partnership formation rules, the partner also does not have to recognize income when the property is contributed to the partnership. Income will be realized by the partnership when the accounts receivable are collected and allocated to the partner who contributed the property.
Unrealized receivables also include some items which are not customarily regarded as a receivable. These items include (1) depreciation recapture, (2) market discount bonds, and (3) short-term obligations.\textsuperscript{51}

The definition of inventory items is very broad and includes more assets than under the customary definition of inventory. It includes all assets other than capital assets and trade or business assets.\textsuperscript{52} Thus, assets which meet the definition of unrealized receivables also meet the definition of inventory items.

\textbf{TAX SAVER!!} Valuation at the time of transfer is very important. The above rules prohibit the conversion of built-in capital losses to ordinary losses. However, if the taxpayer can show capital asset property had not declined below its basis at the time of contribution, conversion to ordinary loss is possible if (1) it declines in value when it is held by the partnership, and (2) it is considered ordinary income property in the hands of the partnership.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

20. True or False. Jacqui Johnson contributes land to a partnership in exchange for a partnership interest. It was a capital asset in the hands of Jacqui. If the partnership sells the land in the future, the character of the gain or loss always will be capital.

Solutions

20. \textbf{False is the correct response.} Generally, the character of income or loss recognized by the partnership is determined at the partnership level. If the partnership uses the land in its business or held it as inventory and it had \textit{appreciated} at the time of contribution, it would not be included in one of the three exceptions described above. In this case, the character of the gain could be trade or business income or ordinary income.

\textbf{True is the incorrect response.} On the other hand, for capital loss property, the character is determined at the partner level. If the land had declined in value at the time of contribution, any built-in loss at the time of contribution would be classified as capital regardless of how the partnership uses the land in its business (investment, trade or business property, or inventory). See Example 15 above.

C.4 Partnership Elections and Taxable Year

In accordance with the entity concept, most elections are made at the partnership level.\textsuperscript{53} Thus, accounting elections such as (1) depreciation method, (2) accounting method, and (3) method of inventory valuation are elected by the partnership. Permitting each partner to elect his own unique set of elections would be an administrative nightmare to the IRS.
Only three elections are permitted at the partner level. They relate to the tax treatment of (1) foreign taxes, (2) mining exploration expenditures, and (3) income from the discharge of indebtedness.  

Although the law is quite restrictive, the partnership also must choose a taxable year. The choice of taxable year is important because it determines when the income from the partnership is reported by the partners. The partner's share of a full year's income of the partnership is reported by a partner for his taxable year in which the partnership's taxable year ends. Thus, income from the partnership could be earned partially in one year but not reported until the next year.

Example 16

A partnership has a January 31 year end. All of its partners are individual taxpayers reporting on the calendar year. For the fiscal year ending 1/31/12 the partnership's ordinary income amounted to $100,000.

Although 11 months of the partnership income were earned in 2011, the total income is reported on the individuals' 2012 tax returns. Thus, the partnership has deferred the reporting of 11 months of income to the following year.

Unless a business purpose is established (see Section C.42 below), generally the partnership must follow a three-step procedure in determining its required year end:

1. It must adopt a taxable year which is the same as its partners who, in the aggregate, own greater than 50% of the interests in partnership profits and capital.
2. If unable to meet #1, it must adopt a taxable year which is the same as its principal partners.
3. If unable to meet #2, it must adopt a calendar year end or such other period as prescribed by the Treasury.  

For purposes of step #1, the partners included in the majority must have owned their interests in profits and capital for the three preceding years, or during the entire existence of the partnership if the partnership has been in existence less than three years. For purposes of step #2, a principal partner is defined as a partner having an interest of 5% or more in partnership profits or capital.

Example 17

The NewPart Partnership consists of 9 partners. Partner A, a corporation with a June 30 year end, owns 40% of the partnership. Partners B, C, D, and E are individuals each owning 10%. Partner F, a corporation with a September 30 year end, owns 11%. Finally, partners G, H, and I are individuals each owning a 3% interest in the partnership.
Step #1 is not satisfied since only 49% of the partners have the same year end (Partners B - E and G - I have a calendar year, while the other two partners report on different year ends). Thus, no majority of partners report on the same year. Step #2 also is not met since the principal partners (A - F) have different taxable years. Thus, it would appear that Step #3 requires a calendar year end (However, see Section C.41 below).

C.41 Least Aggregate Deferral of Income

The Treasury Department has issued regulations concerning the required taxable year if for any taxable year a partnership's taxable year can not be determined by reference to the taxable year of its partners owning a majority interest, or by reference to the taxable year of all of its principal partners (neither steps 1 nor 2 described above are satisfied). In this case, the regulations generally require the partnership to choose the taxable year which results in the least aggregate deferral of income (LADI). It is important to emphasize that a business purpose for a different taxable year overrides this requirement.

If the partnership has many partners with different year ends, this requirement may be quite burdensome to meet. Additionally, if there are many sales of partnership interests, the partnership may be required to change its year end often.

The LADI concept is basically a weighted average computation. Aggregate deferral is the sum of the following product for each partner:

\[
\text{Number of Months of Income Deferral for each Partner} \times \text{The Partner's Interest in Partnership Profits}
\]

The partner's taxable year that produces the lowest sum when compared to the other partners' taxable years is the taxable year resulting in the LADI. Thus, the required taxable year will be the taxable year of at least one of its partners. If there is more than one LADI year, the partnership may select any one of those taxable years. If the LADI Year produces a deferral which is .5 less than the aggregate deferral of the current year, the current year is retained. This is required, not elective.

Example 18

Partnership P is owned by two partners, A and B. Partnership P reports on a June 30 fiscal year. Partner A's fiscal year is June 30 and partner B's fiscal year is July 31. Each owns a 50% interest in the profits of the partnership. The aggregate deferrals for reporting on a June 30 and July 31 year end are .5 and 5.5, respectively, computed as follows:
Since the June 30 year end results in the least aggregate deferral, the partnership must retain its June 30 fiscal year.

**Example 19**

The facts of Example 18 are the same except that A reports on the calendar year and B reports on a November 30 fiscal year. The partnership will have to change its fiscal year from June 30 to November 30, since its aggregate deferral is less than that for the calendar year end and is at least .5 reduction from the current year (June), as shown below:

<table>
<thead>
<tr>
<th># of Months</th>
<th>Test 6/30</th>
<th>Year End</th>
<th>Interest</th>
<th>Deferred</th>
<th>Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>6/30</td>
<td>12/31</td>
<td>.5</td>
<td>6</td>
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</tr>
<tr>
<td>Partner B</td>
<td>11/30</td>
<td>11/30</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Aggregate Deferral 5.5

<table>
<thead>
<tr>
<th># of Months</th>
<th>Test 6/30</th>
<th>Year End</th>
<th>Interest</th>
<th>Deferred</th>
<th>Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner A</td>
<td>12/31</td>
<td>12/31</td>
<td>.5</td>
<td>1</td>
<td>.5</td>
</tr>
<tr>
<td>Partner B</td>
<td>11/30</td>
<td>11/30</td>
<td>.5</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Aggregate Deferral .5

### TAX SAVER!!

Note that none of the above rules has to be followed if the taxpayer can demonstrate a business purpose for the chosen year end. See Section C.42 below.

**C.42 Business Purpose**

If the partnership can establish a **business** purpose to the satisfaction of the Internal Revenue Service, then the taxable year rules of Sections C.4 and C.41 above do not apply. Also, IRC Section 444 (see Section C.43 below) is not applicable.
For new partnerships, there is no guidance as to what constitutes a business purpose. Here are some reasons which are not sufficient to establish a business purpose:

1. The use of a particular year for regulatory or financial accounting purposes.
2. The hiring patterns of a particular business.
3. The use of a particular year for administrative purposes, such as the admission or retirement of partners or shareholders, promotion of staff, and compensation or retirement agreements.
4. The fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis.
5. The year was suggested by the Natural Business Committee of the AICPA and it is used for financial purposes.
6. The accountant would give the client a reduced rate because it was not at a peak time.
7. It has used this year for 15 years and it would lose its record keeping consistency.
8. It facilitates the timely filing of its owners.\textsuperscript{60}

A business purpose for a particular year end may be established by satisfying the requirements of Revenue Procedure 83-25.\textsuperscript{61} This ruling establishes a natural business year if at least 25% of the entity's gross receipts are recognized in the last two months of the 12-month period in question. This 25% requirement also must be satisfied during the two preceding 12-month periods. If the taxpayer qualifies for more than one natural business year, the fiscal year with the highest three-year average gross receipts percentage for the applicable two-month period generally is the taxpayer's natural business year. Note that since the 25% gross receipts test must be satisfied over the last three years, new businesses cannot use this test to establish a business purpose for their taxable year.

\textbf{Example 20}

A partnership currently reports its activities on a June 30 fiscal year. An analysis of the last 12-months of gross receipts reveals that gross receipts for May and June were $10,000 and $20,000 respectively. Total gross receipts for the year were $100,000.

For the preceding 12-month period, the partnership recognized 30% ($(10,000 + 20,000)/$100,000)$ of its gross receipts during the last two months. Assuming that the 25% gross receipts test is met for the two preceding 12-month periods, the partnership would be able to retain its June 30 fiscal year.
Revenue Procedure 87-52,\textsuperscript{62} considers the following scenarios to be acceptable business reasons for a partnership tax year:

1. It can satisfy the 25% gross receipts test in November and January. It chooses November even though it is lower than January. It is approved because it results in less deferral than would the January fiscal year.

2. It can satisfy the 25% gross receipts test in two of three years. In the third year, there was a strike for several months.

3. Although it had used the cash method of accounting over the past three years, it has changed to the accrual method. Under the accrual method, the 25% test is satisfied.

4. Due to weather conditions, the business is operational only from September through May. It therefore chooses May 31, even though it does not satisfy the 25% gross receipts test.

The first three reasons concern the 25% gross receipts test, and therefore do not add to the types of business purposes that may be established. The fourth reason is subjective, when compared to the objective 25% test. Although, this fourth reason may be rare, it may provide the tax adviser with an alternative approach to satisfying the business purpose requirement. If the business is truly seasonal, it may be granted a business purpose even if the 25% test is not satisfied.

\textbf{C.43 The IRC Section 444 Election}

Partnerships may adopt or change to a taxable year which results in a deferral period of three months or less, providing that the deferral period is less than for the original taxable year.\textsuperscript{63} The deferral period is defined as the difference between the number of months between the close of the tax period elected and the close of the required taxable year.\textsuperscript{64}

\textbf{Example 21}

A partnership is owned by three individuals and its required taxable year is a calendar year. It has been reporting on a fiscal year ending June 30 but it no longer is able to justify a business purpose for this year end.

The partnership must adopt either a December 31 year or elect to change to a fiscal year resulting in a deferral period of less than three months. Thus, the entity could change to a September 30, October 31, or November 30 year end.

\textbf{Example 22}

Assume the same facts as in Example 21 except that the partnership's current fiscal year is October 31. Since its current deferral is less than 3 months, it may retain its current fiscal year or change to a November 30 year end.
Example 23

Refer to the facts of Example 21. Rather than elect IRC Section 444, the partnership changed to a calendar year end for 2011. Thus it filed a short period return for the period 7/1/11 -12/31/11.

In 2012, it is considering changing its year end under IRC Section 444. Since its deferral period is now zero months (the number of months between its current taxable year and required taxable year), it is precluded from making an IRC Section 444 election to change its taxable year.

For new entities, the deferral period limitation resulting from its current taxable year is not applicable. Thus, new entities may adopt a fiscal year which does not result in a deferral of more than three months. Therefore, new partnerships with a 12/31 required year may adopt a fiscal year ending 9/30, 10/31, or 11/30.

The taxpayer elects IRC Section 444 by filing Form 8716 by the earlier of:

1. The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election first will be effective, or

2. The due date (not including extensions) of the income tax return resulting from the IRC Section 444 election.63

Example 24

A partnership begins business on 9/10/11 and is qualified to make an IRC Section 444 election to use a 9/30 taxable year. The due date for filing Form 8716 is January 15, 2012 (the earlier of February 15 or January 15).

Example 25

Assume the same facts as in Example 24 except that the partnership began its operations on October 20, 2011. It adopts a 9/30 taxable year under IRC Section 444. The due date for filing Form 8716 is March 15, 2012 (the earlier of March 15, 2012 (5th month following first month) or January 15, 2013 (due date of the tax return).

For taxpayers electing IRC Section 444, tax payments must be made by the electing entity. If an applicable year is the entity's first taxable year, the required payment is zero. Conceptually, the payments are intended to approximate the tax saved by the entity owners as a result of deferring the reporting of a portion of the entity's taxable income until the succeeding year. Form 8752 must be filed and the required payment must be made by May 15 of the calendar year following the calendar year in which the applicable election year begins.66 If the required payment is not made by the due date, the entity may have to pay a penalty equal to 10% of the underpayment. A refund may be claimed if the cumulative payments exceed the estimated tax liability.
** REVIEW QUESTIONS AND SOLUTIONS ** (Based on Sections C.4 - C.43)

Questions

21. True or false. A partnership has three equal partners – individuals A and B, who file a calendar-year tax return and Corporation C, which files its return on June 30. Assuming that the partnership cannot base its taxable year on the basis of business purpose, it may choose to file its partnership tax return on June 30 or December 31.

22. A new partnership is in the process of electing a taxable year. It began its business on June 1 and its required taxable year is December 31. Which one of the following statements is true?

   a. The partnership may elect under IRC Section 444 to report its activities on an August 31 fiscal year-end.

   b. If the partnership wants to make the IRC Section 444 election and choose a November 30 year end, it must make the election by November 15 of the first taxable year.

   c. It may choose a July 31 year end under the 25% gross receipts test if the total gross receipts for June and July are at least 25% of the total gross receipts for the seven-month period ending December 31.

Solutions

21. **False is the correct response.** Since more than 50% of the interests in the partnership report on a calendar year, the required taxable year is December 31.

   **True is the incorrect response.** There can be only one required taxable year under the IRC and Treasury regulations.

22. **"B" is the correct response.** The IRC Section 444 election must be made the earlier of (1) the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election first will be effective, or (2) the due date of the income tax return. In this case, the two dates are (1) November 15 of the current year and (2) March 15 of next year making the earlier date November 15.

   **"A" is an incorrect response.** New entities may adopt a fiscal year which does not result in a deferral of more than three months. An August 31 fiscal year-end would result in a four month deferral of income, which is not permitted.

   **"C" is an incorrect response.** The 25% gross receipts test is not available for new businesses since the test must be satisfied over the last three years.

C.5 Determination of Distributive Share

Generally, a partner's distributive share of income, gain, loss, deduction, or credit is determined at the partnership level, as provided in the partnership agreement. A partner may have a different interest in profits, losses, and capital. For example, the partnership agreement may provide that a partner has a 20% interest in profits and a 40% interest in losses. In limited
partnerships, it is more common than in general partnerships to have varying interests in profits, losses, and capital. If the partnership agreement does not specify the partner's interest, or if the allocation of an item does not have substantial economic effect, the partner's partnership interest is determined by considering all the facts and circumstances.68

A capital account can be viewed as the value of the partner's interest if he liquidated it. For example, if a partner contributed $10,000 to a partnership and liquidated his interest the next day, chances are he would receive his $10,000 back unless there were some unusual events that took place during that day. As time passes, economic events such as (1) appreciation or decline in the value of partnership assets, (2) partnership profits and losses, and (3) property distributions will affect the partner's capital account. A general formula for maintaining a partner's capital account is as follows:

<table>
<thead>
<tr>
<th>Beginning Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Capital Contributions During the Year</td>
</tr>
<tr>
<td>+ Income Allocated For the Year</td>
</tr>
<tr>
<td>- Partnership Distributions</td>
</tr>
<tr>
<td>- Losses Allocated For the Year</td>
</tr>
<tr>
<td><strong>Ending Balance</strong></td>
</tr>
</tbody>
</table>

**Example 26**

Bill Wells is a 30% partner in a partnership. At the beginning of the current taxable year, Bill had a $25,000 balance in his capital account. He contributes an additional $10,000 in cash during the year. The partnership has $40,000 of income for the taxable year, and Bill receives $7,000 in cash distributions. Bill's ending balance in his capital account equals $40,000 ($25,000 + $10,000 + (30% x $40,000) - $7,000).

The above formula does not take into account the changes in value of partnership assets, including goodwill. If a partner were to liquidate his interest, such valuation changes typically would be made at the time of liquidation.

**C.51 Special Allocations**

Unlike S Corporations, a partnership may change a partner's distributive share of items (e.g., profits and losses) from time to time if circumstances dictate it. For example, if a partner makes an additional capital contribution during a period where the partnership is in need of capital, the
partnership agreement could be amended to allocate all of the partnership losses to the contributing partner for a specified time, after which the partner's interest in losses would revert to the previous interest. Such changes are termed special allocations. They are allowed only if the allocation has substantial economic effect. Historically, there has been a lack of taxpayer understanding of this standard. As a result, the Treasury issued three sets of regulations in this area during the last half of the 1980's. These regulations are complex and beyond the scope of this course. The rules are briefly explained below.

In order for an allocation to have substantial economic effect, the allocations must be substantial and have economic effect. The substantiality test prohibits transitory allocations and allocations of income or deductions to different partners on the basis of character (such as capital gain, ordinary income, and tax-exempt income) without significantly affecting the partners' capital accounts (altering their long-term capital interests). For example, if in an equal two-partner partnership, the first $10,000 of partnership tax-exempt income was allocated to the high tax bracket partner and $10,000 of partnership ordinary business income was allocated to a lower-tax bracket partner, their relative capital accounts have not changed so this would not meet the substantiality test.

With respect to the economic effect test, the following three requirements must be satisfied:

1. The allocation must affect the partner's capital account.
2. Capital accounts must be used in determining the partner's liquidation proceeds.
3. The partnership agreement must require that a partner restores his negative capital account balance at the time of liquidation (there are some exceptions to this requirement).

Example 27

The Rosebud Partnership has two partners Rose and Bud. Assume that the partnership agreement originally provided for an equal allocation of profits, losses, and capital. At the beginning of 2012, each had a $100,000 capital account balance. On 1/1/12, Rose contributes an additional $50,000. The partnership agreement is amended to provide that Rose be allocated 100% of the next $100,000 of tax losses. In 2012, the partnership's actual losses were $80,000. Accordingly, all of the loss was allocated to Rose.
In order for this loss allocation to be upheld, the partnership agreement should be amended to clarify that the special allocation affects Rose's capital account and that liquidation proceeds be based on the partners' capital account balances. Based on the above, the ending capital account balances for Rose and Bud at the end of 2012 would equal $70,000 and $100,000 respectively, computed as follows:

<table>
<thead>
<tr>
<th></th>
<th>Rose</th>
<th>Bud</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance at 1/1/12</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>+ Capital Contributions During 2012</td>
<td>50,000</td>
<td>-</td>
</tr>
<tr>
<td>+ Income Allocated For the Year</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>- Partnership Distributions</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>- Losses Allocated For the Year</td>
<td>(80,000)</td>
<td>-</td>
</tr>
<tr>
<td>Balance at 12/31/12</td>
<td>$70,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

If the Rosebud partnership liquidated on December 31, 2012, and all of the assets were sold at their book values (no gain or loss), Rose would receive $70,000 and Bud would receive $100,000, even though Rose had made an additional $50,000 contribution during the year. Had the losses been allocated equally, the capital account balances for Rose and Bud at year end would equal $110,000 and $60,000 respectively. Thus, for an additional $40,000 of loss ($80,000 - $40,000 if shared equally), Rose would be giving up $40,000 of cash if the partnership liquidated at the end of 2012. Since the maximum tax rate in 2012 is only 35%, the tax benefit derived from the extra loss allocation is far less than the loss of liquidation proceeds.

In this situation, the special allocation would not be beneficial to Rose. There are remedies to this potential tax planning disaster (if your client were Rose) such as gain charge back provisions, which may restore Rose's capital account. For tax advisers who are unfamiliar with these regulatory rules, it would be prudent to advise clients that special allocations have potential pitfalls.

**C.52 Mandatory Allocations With Respect to Contributed Property**

When a taxpayer contributes property to a partnership, seldom does the fair market value of the property equal its basis at the time of contribution. Since the contributing partner generally recognizes no gain or loss from the property contribution and the basis of the property carries over to the partnership, there exists a built-in gain or loss at the time of the contribution. IRC Section 704(c) requires that any income, gain, loss, and deduction must be shared among the partners so as to take account of the variation between the basis of the property and its fair market value at the time of contribution. As a result, partnerships must account separately for contributions of property.
Implicit in this provision is that the fair market value of the property has been established at the time of contribution. An analysis of Section 704(c) allocations is provided in the course “Partnership Taxation – Part II.”

Example 28

In 2010, Jill Sanders contributed land with a fair market value of $100,000 and a basis of $60,000 for a 20% interest in the ABC Partnership. In July 2012, the partnership sells the land for $110,000. Jill must report $42,000 of the gain ($40,000 of pre-contribution gain and 20% of the $10,000 post-contribution gain).

** REVIEW QUESTIONS AND SOLUTIONS ** (Based on Sections C.5 - C.52)

Questions

23. True or False. Generally, partnerships adjust their partnership capital accounts annually to reflect changes in the value of partnership assets.

24. Rob and Cindy each contribute $100,000 cash to the RC partnership in January 2012. Because of extensive losses during the year, Rob kicks in an additional $40,000. Losses for the year were $60,000 and it is agreed that Rob will be allocated all of the losses for 2012. Assume that the book value of the assets equal their actual fair value and the $60,000 special allocation passed the economic effect test. If the RC partnership sold its assets for book value and liquidated on December 31, 2012, how much would Rob receive?

   a. $80,000.
   b. $90,000.
   c. $110,000.

Solutions

23. **False is the correct response.** Since an accounting transaction has not taken place, generally adjustments for asset value changes are made to a partner’s capital account only when there has been a change in ownership (such as in the case of a retirement of partner, an admission of a new partner, or the liquidation of the partnership).

**True is the incorrect response.** Capital accounts from year to year are adjusted for transactional events (income and expenses, capital contributions, distributions, etc.) rather than asset value changes.

24. "**A" is the correct response.** In order for the $60,000 special allocation of losses to Rob to have economic effect, capital accounts must be used to determine liquidation values. In this case Rob’s capital account is $80,000 ($100,000 + $40,000 - $60,000) and Cindy’s capital account is $100,000. If all assets were sold for book value, there would be $180,000 available for distribution ($100,000 + $100,000 + $40,000 - $60,000). As a result, Rob’s distribution equals $80,000 and Cindy’s distribution equals $100,000.

"**B" is an incorrect response.** $90,000 would equal 50% of the remaining cash of the partnership. This would not pass muster under the special allocation rules or under general partnership law dealing with equitable distribution.
"C" is an incorrect response. $110,000 would be correct if the special allocation had not been made ($100,000 + $40,000 - $30,000). Cindy would receive $70,000 ($100,000 - $30,000).

D. MAINTENANCE OF PARTNER'S BASIS IN PARTNERSHIP INTEREST

The determination of a partner's basis in his partnership interest at the time of partnership formation or initial partner contribution was discussed in Section B.9. A partner's basis also is referred to as "outside basis," whereas the basis of the assets held by the partnership is referred to as "inside basis." This section updates the partner's outside basis for the effect of partnership operations. The partner's basis is calculated each year as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis at the Beginning of the Year (or immediately after formation in the first year of the partnership)</td>
<td>(A) Basis at the Beginning of the Year (or immediately after formation in the first year of the partnership)</td>
</tr>
<tr>
<td>Basis of Additional Property Contributions During the Year</td>
<td>(B) + Basis of Additional Property Contributions During the Year</td>
</tr>
<tr>
<td>Distributive Share of Income Items of the Partnership</td>
<td>(c) + Distributive Share of Income Items of the Partnership</td>
</tr>
<tr>
<td>Increase in Partner's Share of Partnership Liabilities</td>
<td>(D) + Increase in Partner's Share of Partnership Liabilities</td>
</tr>
<tr>
<td>Property Distributions</td>
<td>(E) - Property Distributions</td>
</tr>
<tr>
<td>Distributive Share of Loss Items of the Partnership</td>
<td>(F) - Distributive Share of Loss Items of the Partnership</td>
</tr>
<tr>
<td>Decrease in Partner's Share of Partnership Liabilities</td>
<td>(G) - Decrease in Partner's Share of Partnership Liabilities</td>
</tr>
<tr>
<td>Basis at the End of the Year</td>
<td>= Basis at the End of the Year</td>
</tr>
</tbody>
</table>

Note that items (E), (F), and (G) are "mirror images" of items (B), (C), and (D), respectively. Since items (A) and (B) were covered in Section B.9 above, only the remaining items are discussed here.

D.1 Distributions

This section focuses on the tax treatment of nonliquidating distributions. The tax treatment of liquidating distributions, as well as basis allocation rules when multiple properties are distributed, will be discussed in the second partnership course. For cash distributions, the basis adjustment is straightforward. The partner's basis for the partnership interest is reduced by the amount of cash distributed, but it may not be reduced below zero. In the event that the cash distributed exceeds the partner's basis, gain is recognized to the extent that the cash distributed exceeds the basis of the partner's interest in the partnership immediately before the distribution.
Example 29

At the end of the year, the ABC Partnership makes a $2,500 cash nonliquidating distribution to each of its two partners. Partner A has a $5,000 basis in the partnership and Partner B has a $1,000 basis in the partnership prior to the distribution.

Partner A's basis after the distribution equals $2,500 ($5,000 - $2,500). Partner B's basis is zero and his gain recognized is $1,500 ($2,500 - $1,000).

Advances or drawings of money or property against a partner's distributive share of income are treated as current distributions made on the last day of the partnership taxable year. Thus, generally a basis computation needs only to be made at year end.

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**TAX SAVER!!** The above rule concerns the timing of computing basis only with respect to **advances or drawings from profits**. Thus, the partnership agreement should make clear that such monthly distributions are advances, and if the total advances exceed the profits, the excess must be paid back to the partnership. Otherwise, the advances could be treated as distributions of capital and trigger gain, as in the case of Partner B in Example 29.

For nonliquidating property distributions, generally the partner's basis is reduced by the basis of the property distributed. In turn, the basis of the property in the hands of the partner equals the basis of the property in the hands of the partnership. This treatment is consistent with property contributions, which generally requires a carryover basis for the contributed property. If the basis of the property exceeds the partner's basis, the partner's basis in the partnership interest is reduced to zero. However, generally no gain is recognized by the partner as a result of the property distribution. Instead, the property's basis in the hands of the partner is reduced to the partner's basis in his partnership interest immediately before the distribution. This is known as the basis limitation rule.

Example 30

Refer to the facts of Example 29. Assume that, instead of a cash distribution, the partnership distributes $2,500 worth of property to each partner. Assume that the basis of the property distributed to each partner is $1,500.

Partner A's basis is reduced by the basis of the property distributed, or $1,500, leaving a balance in A's basis in his partnership interest of $3,500 ($5,000 - $1,500). Partner A's basis in the property distributed is $1,500. Partner B's basis is less than the basis of the property distributed. Thus, his basis is reduced to zero, since a negative basis is not allowed ($1,000 - $1,500). Although no gain is recognized by
Partner B for the excess, the basis of the property distributed to Partner B equals the amount of reduction in B’s basis in his partnership interest as a result of the distribution. Thus, the basis of the property to Partner B equals $1,000.

If multiple properties are distributed to a partner during the year and the basis limitation rule described above applies, it is important to know the ordering rules applicable to property distributions. The basis of the partner's interest is allocated to the properties in the following order: (1) cash (and marketable securities treated as cash as discussed below); (2) unrealized receivables and inventory; and (3) other property. This ordering is actually favorable to partners since it lessens the potential for gain recognition (gain is recognized only if the cash distributed exceeds the partner’s outside basis which is determined prior to any distributions) and it reduces the chance that the basis limitation rule will apply to ordinary income property (since inventory items are considered before other property).

There are three exceptions to the general rule of gain and loss nonrecognition for nonliquidating partnership property distribution. First, for distributions of marketable securities, the fair market value of the securities is treated as money. Thus, gain will be recognized to the extent that the fair market value of the marketable securities exceeds the partner's basis in partnership interest. The fair market value amount is reduced by the difference between (1) the partner's share of the net appreciation of the marketable securities immediately before the distribution and (2) the partner's share of the net appreciation of the marketable securities immediately after the distribution.

Example 31

A and B are equal partners. A has a basis of $250. Security X, the partnership's only security, is distributed to A. It has a FMV and Basis of $500. As a result, A recognizes $250 ($250 - $500) of gain.

Example 32

A and B are equal partners. A has a basis of $100. The partnership also owns three securities as follows: X (FMV - $100, Basis - $70); Y (FMV - $100, Basis - $80); and Z (FMV - $100, Basis - $110). Partner A’s share of the net appreciation of the marketable securities is $20 (50% x ($30 + $20 - $10)). Assume security X is distributed to A. This results in lowering his share of net appreciation of the marketable securities held by the partnership to $5 (50% x ($20 - $10)). As a result, the amount of the distribution is $85 which is $100 less the $15 difference between the partner's share of pre-distribution appreciation in marketable securities ($20) and post-distribution appreciation in marketable securities ($5).
Second, a partner will recognize gain from a property distribution if the fair market value of the property distributed to the partner exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution to the extent of any pre-contribution gain. Third, if the distribution is considered a disproportionate distribution, gain or loss may be recognized by the partner or partnership. The latter two exceptions are covered in the second partnership course (Partnership Taxation – Part 2).

**REVIEW QUESTIONS AND SOLUTIONS**

Questions

25. On the last day of the taxable year, the partnership distributes $20,000 worth of land to Partner A pursuant to a nonliquidating distribution. The basis of the property (inside basis) is $15,000. The basis of Partner A's interest immediately before the distribution (outside basis) is $14,000. Partner A has not contributed property with a pre-contribution gain. How much gain or loss must Partner A recognize as a result of the distribution?
   
   a. $ -0-.
   b. $1,000 gain.
   c. $6,000 gain.

26. Refer to the facts of Example 25. What is the basis of the land in the hands of Partner A (after the distribution)?

   a. $20,000.
   b. $15,000.
   c. $14,000.

Solutions

25. "A" is the correct response. For nonliquidating distributions, generally there is no gain or loss recognition unless the distribution is cash and the cash distribution exceeds the basis of the partner’s interest immediately before the distribution.

   "B" is an incorrect response. $1,000 would be correct if gain were recognized to the extent that the basis of the property distributed exceeded the basis of the partner’s interest immediately before the distribution.

   "C" is an incorrect response. $6,000 would be correct if gain were recognized to the extent that the fair market value of the property distributed exceeded the basis of the partner’s interest immediately before the distribution.

26. "C" is the correct response. Generally, the basis of the property distributed to the partner equals the basis of the property in the hands of the partnership. However, if the basis of the partner’s interest immediately before the distribution is less than the property’s basis, the basis is reduced to the partner’s outside basis, or $14,000 in this case and the partner’s outside basis is reduced to zero.
"A" is an incorrect response. $20,000 represents the fair market value of the property and it is not used to determine the basis of property distributed to a partner.

"B" is an incorrect response. $15,000 would be correct if the partner’s outside basis before the distribution was $15,000 or greater.

D.2 Distributive Share of Income and Loss Items

A partner's basis is increased by both taxable and nontaxable income items of the partnership.\textsuperscript{84} It may seem that this treatment provides a double benefit for nontaxable items, but, in fact, this adjustment is necessary to preserve the nontaxable status of the nontaxable income. Recall that distributions reduce basis. If a partner were not allowed to increase his basis for his share of nontaxable income, the net effect on his basis would be a downward adjustment after the nontaxable income was distributed to the partner.

Example 33

Assume that Partner A's basis in the partnership on January 1 was $1,000. During the year the partnership earned nontaxable income, of which A's share was $600. The $600 was distributed to him at year end.

Partner A is allowed to increase his basis by $600 upon the allocation to him of his share of nontaxable income. When it is distributed, his basis is reduced by $600. Thus, the net effect of the income and distribution on his basis is zero. If he were not permitted to increase his basis, his adjusted basis after the distribution would equal $400 ($1,000 - $600). Thus, if he sold his partnership interest at a gain immediately after the distribution, his total gain realized would be $600 more than if the partnership never had earned and distributed the nontaxable income thereby not preserving its tax exempt status.

A partner's share of partnership loss or deduction items reduces the partner's basis.\textsuperscript{85} Consistent with the above rationale for increasing basis for nontaxable income items, the partner's basis is decreased by nondeductible items, such as penalties, fines, and expenses attributable to tax-exempt income.

Example 34

Assume that Partner A's basis and fair market value of his partnership interest on January 1 were both equal to $1,000. During the year, the only partnership activity was the payment of nondeductible fines, of which A's share was $600. At the end of the year, the partner sold his interest in the partnership for $400.

The law requires the downward adjustment in basis to reflect the nondeductible fines. Thus, the adjusted basis of Partner A's interest is $400 ($1,000 - $600), and no gain or loss is recognized on the sale, since the sales price and basis are equal.
If no downward adjustment were required, Partner A would recognize a $600 loss ($400 - $1,000) on the sale of his partnership interest. That is, the $600 of fines essentially would be deductible, since the value of the partnership was reduced by the fines, with no corresponding reduction in basis.

In Revenue Ruling 96-11, the IRS explains the basis calculations when the partnership makes a charitable contribution of appreciated property. Although the allocation of the charitable deduction is based on fair market value, the partner's basis reduction is based on the basis of the property contributed.

Example 35

Benson Partnership is owned equally by Nicole and Amy. Benson makes a charitable contribution of capital gain property worth $100 in which it has a $60 basis. Benson is not allowed to take a deduction for the contribution. Nicole and Amy are allocated charitable contribution deductions of $50 each (50% partnership interest x $100 property value). Nicole and Amy each must reduce the basis of their partnership interest by $30 (50% partnership interest x $60 basis of property contributed).

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

27. True or False. A partner’s share of tax-exempt income earned by the partnership increases the partner’s outside basis.

Solutions

27. True is the correct response. A taxpayer’s outside basis is increased by his share of income whether taxable or tax exempt.

False is the incorrect response. The purpose of increasing the partner’s basis by the partner’s share of tax-exempt income earned by the partnership is to preserve its tax-exempt status. Without the basis increase, a cash distribution of the partner’s share of tax-exempt income could result in the recognition of income if the distribution exceeds the partner’s outside basis. See Example 33 above.

D.3 Basis Implications of Partnership Liabilities

The inclusion of liabilities in the partner's basis depends on (1) whether the partner is a general or limited partner, and (2) whether the debt is considered recourse or nonrecourse. A general partner operates the partnership and generally shares in the economic risk of loss of all partnership debts except nonrecourse debt.

In contrast, a limited partner by state law is not permitted to manage the partnership and is protected against claims made against the partnership. A limited partner’s maximum loss generally
is limited to his/her actual capital contribution plus any future contributions which are required by the partnership agreement. In some instances, a limited partner may be considered to bear the economic risk of loss if the partner could be held accountable for payment of the debt.\textsuperscript{87} For example, loan guarantees by limited partners may result in the limited partners' bearing the economic risk of loss for at least a portion of the partnership debt. Thus, the arrangements among the partners must be examined in order to determine which partners bear the economic risk of loss for the partnership debt.

Recourse debt is debt for which at least one partner bears the economic risk of loss.\textsuperscript{88} Risk of loss generally means that the partner would be held liable for payment upon the liquidation of the partnership and would not be entitled to reimbursement from another partner.\textsuperscript{89} Conversely, nonrecourse debt is debt for which no partner bears the economic risk of loss.\textsuperscript{90} Nonrecourse loans may be secured, such as in the case of a mortgage on partnership real estate property. Thus, in the event of nonpayment of nonrecourse debt, the creditor may be satisfied only by the property, not by any partner's personal assets. If the property is not sufficient in value to cover the debt, the creditor bears the risk of loss. Such loans are fairly uncommon in general partnerships. With the advent of the tax shelter limited partnership, nonrecourse loans became a very popular means of financing real estate in the 1970s and 1980s. Although still available, "pure" (without guarantees) nonrecourse debt arrangements are less common.

Any increase in a partner's share of partnership debt is considered a contribution of money by the partner to the partnership.\textsuperscript{91} Thus, an increase in partnership debt increases a partner's basis in his partnership interest. The borrowing is treated as if the partner borrowed the amount personally and contributed the funds to the partnership. The partner's share of recourse debt equals the portion of the economic risk of loss for the debt that is borne by the partner.

A partner is considered to bear the economic risk of loss for a partnership liability to the extent that a partner would bear the economic burden of discharging the liability if the partnership were unable to do so. The determination of the extent to which a partner has an obligation to make a payment is based on the facts and circumstances at the time of the determination.\textsuperscript{92} Obligations which would be examined include the following:
1. Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other persons, or to the partnership.

2. Obligations to the partnership that are imposed by the partnership agreement, including agreements which require some or all partners to restore deficit balances in their capital accounts upon the liquidation of the partnership.

3. Payment obligations imposed by state law whether in a form of direct remittances to another partner or a contribution to the partnership.93

In determining the economic risk of loss, the regulations apply an analysis as to who would be responsible for the debt if the partnership liquidated ("constructive liquidation analysis"). Generally economic risk of loss is borne by the partner if the partner would be required to make a payment to the creditor or a contribution to the partnership if (1) all the partnership liabilities became due and payable in full, (2) the partnership's assets (including money) are deemed to be worthless, (3) the partnership disposed of all of its assets in a fully taxable transaction for no consideration, and (4) the partnership allocated its items of income, gain, loss, deduction, and credit for the year among the partners and liquidated the partner's interest in the partnership.94

The following example illustrates how the Treasury examines balances in partners' capital accounts to determine which partner, if any, has the economic risk of loss for partnership liabilities.

Example 36

Whitlam and Frazier form a general partnership with each contributing cash of $40,000. They agree to share profits and losses equally. Distributions in liquidation are made according to the partners' positive capital account balances. Any deficits after liquidation must be restored.

The partnership purchases equipment for $80,000 cash and a recourse purchase note for $150,000. Under the constructive liquidation analysis described above, the liabilities are deemed payable immediately and all assets are deemed worthless resulting in a taxable loss of $230,000. This loss is shared equally as shown below:

<table>
<thead>
<tr>
<th></th>
<th>Whitlam</th>
<th>Frazier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>on formation</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Loss on equipment</td>
<td>(115,000)</td>
<td>(115,000)</td>
</tr>
<tr>
<td>Capital account</td>
<td></td>
<td></td>
</tr>
<tr>
<td>after liquidation</td>
<td>($75,000)</td>
<td>($75,000)</td>
</tr>
</tbody>
</table>

Because each partner is required to restore his deficit balance, Whitlam and Frazier are each obligated to make a contribution of $75,000 with respect to the
$150,000 liability. Thus, each bears $75,000 of the economic risk of loss for the recourse purchase note.

In the above example, the capital account balances at the time of formation were equal. In addition, the partners share profits and losses equally. In this case, as well as in other cases where (1) a partner's profit, loss, and capital interests are the same, and (2) each partner's initial capital contribution is in proportion to the partner's capital interest, the recourse debts can be allocated simply on the basis of the partner's interest in losses.

Example 37

Megan, Ginny, and Beth form a general partnership. Megan's interest in capital, profits, and losses is 50%. The other two partners each have a 25% interest in capital, profits, and losses. Upon formation, Megan contributes $10,000 cash. Ginny and Beth each contribute $5,000 cash. The partnership obtains a $40,000 loan. With the total proceeds of $60,000, it purchases an office for $40,000 and office equipment for $20,000.

If the partnership were constructively liquidated immediately, there would be a taxable loss of $60,000. This loss results because the assets with an adjusted basis of $60,000 are assumed to be worthless and exchanged for no consideration. This loss is shared 50%, 25%, and 25%, as shown below:

<table>
<thead>
<tr>
<th></th>
<th>Megan</th>
<th>Ginny</th>
<th>Beth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account</td>
<td>$10,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>on formation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss on assets</td>
<td>(30,000)</td>
<td>(15,000)</td>
<td>(15,000)</td>
</tr>
<tr>
<td>Capital account</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>after liquidation</td>
<td>(20,000)</td>
<td>(10,000)</td>
<td>(10,000)</td>
</tr>
</tbody>
</table>

Because each partner is required to restore her deficit balance, Megan is obligated to contribute $20,000 and Ginny and Beth are each obligated to contribute $10,000. Thus, Megan bears $20,000 of the economic risk of loss and Ginny and Beth each bear $10,000 of the economic risk of loss for the $40,000 debt.

Note that since (1) each partner's profit, loss, and capital interest are the same (either all 50% or all 25%), and (2) each partner's initial capital contribution was in proportion to the partner's capital interest (Megan's capital contribution and partnership interest were twice that of Ginny's and Beth's), the $40,000 debt could be allocated simply on the basis of the partner's interest in losses (50% to Megan and 25% each to Ginny and Beth).

Generally, nonrecourse debt is allocated on the basis of the partners' profits interests. Since no partner is personally liable for nonrecourse debt, all partners (both general and limited partners) "share" in the debt for purposes of basis calculations. Before the general allocation rule applies, the regulations require two other allocations of nonrecourse debt among the partners to reflect (1) the
partners' shares of any partnership minimum gain under Treasury Regulation Sections 1.704-2(g) and (2) mandatory allocations with respect to contributed property (discussed briefly in Section C.52 above). The purpose of these allocations is to coordinate the treatment of nonrecourse liabilities under the Section 704(b) regulations. The allocation of partnership minimum gain is complex, and applies only in fairly limited cases. It is not covered in this course.

While an increase in a partner's share of partnership liabilities is considered a partner contribution to the partnership, a decrease in a partner's share of debt is considered a partnership cash distribution to the partner. Since cash, in fact, has not been distributed to the partner, a reduction in liabilities is considered a "constructive cash distribution."

Example 38

Linda and Jane form a real estate partnership. Linda contributes $50,000 cash. Jane contributes land with a fair market value of $100,000, and basis of $40,000. The land is subject to a $50,000 nonrecourse mortgage which the partnership assumes. In the event that the partnership is unable to make payments on the property, the creditor's only recourse is to claim the property. That is, the creditor may not seek payment from either Linda or Jane. Profits, losses, and capital are shared equally.

The debt is considered nonrecourse debt since neither partner bears any economic risk of loss in the event that the property declines in value and/or the partnership is unable to continue making payments on the debt. If the partnership disposed of the property in full satisfaction of the debt, the partnership would recognize $10,000 of gain ($50,000 debt less $40,000 basis).

The partnership provisions dealing with mandatory allocations with respect to contributed property (Section C.52 above) require the allocation of the $10,000 gain to Jane. Thus, the first $10,000 of debt is allocated to Jane. The remaining $40,000 of debt is shared in accordance with the partners' interests in partnership profits. Since each partner has a 50% interest, each partner is allocated $20,000. In summary, Linda's share of the debt is $20,000 and Jane's share of the debt is $30,000. The bases of their partnership interests are $70,000 and $20,000, computed as follows:

<table>
<thead>
<tr>
<th>Basis of Property Transferred</th>
<th>Linda</th>
<th>Jane</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of Property Transferred</td>
<td>$50,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Debt Allocation (considered to be a cash contribution)</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Debt Transferred (considered to be a cash distribution)</td>
<td></td>
<td>(50,000)</td>
</tr>
<tr>
<td>Basis of Partnership Interest</td>
<td>$70,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>
Although the incurrence of debt and its repayment have a net effect of zero on the basis of a partner's interest in the partnership, the repayment of debt may cause the partner to recognize gain. This result may occur because the debt was used to absorb a previous year's loss deduction and the constructive distribution exceeds the partner's basis in his partnership interest. Recall from Section D.1 above that if a distribution of cash exceeds the partner's basis, gain must be recognized by the partner to the extent that the cash exceeds the partner's outside basis in the partnership interest.

Example 39

Assume that at the beginning of the year Partner A has a $5,000 basis in the partnership and Partner B has a $1,000 basis in the partnership. The only activity of the partnership is the payment of $5,000 of recourse debt. Partners A and B share profits and losses equally. In addition, each partner shares equally in the economic risk of loss of all recourse debts.

Since each partner shares equally in the debt, the reduction of debt is considered a $2,500 cash distribution to each partner. Partner A's basis after the distribution equals $2,500 ($5,000 - $2,500). Partner B's basis is zero and his gain recognized is $1,500 ($2,500 - $1,000).

Partner B in Example 39 may find it difficult to understand that he has $1,500 of recognized gain when he received no actual cash. Thus, the tax adviser should insure that the client is informed of the hazards of partnership liabilities. The client should understand the importance of consulting the tax adviser whenever a large reduction in partnership liabilities is anticipated.

If a debt were paid off during the year, there was a question as to whether the constructive distribution rules had to be applied at the time of the debt repayment or at year end. The IRS, in Revenue Ruling 94-4, states that a deemed distribution of money resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money which is taken into account at the end of the partnership taxable year.98

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**TAX SAVER!!** Before paying off a large debt, the bases of the partners should be examined to determine if gain would result from the constructive cash distribution. Either the debt payment could be postponed or the partnership could give the partners the option to increase their basis by additional contributions or assume the debt outside the partnership.
** REVIEW QUESTIONS AND SOLUTIONS **

Questions

28. True or False. Partnership recourse debt may never be included in the outside basis of a limited partner.

29. Steve and Cheryl form a general partnership by contributing cash of $40,000 and $20,000 respectively. Steve's share of profit and loss is 60% while Cheryl's share is 40%. The partnership agreement states that liquidating distributions are made according to the partner's positive capital account balances and any deficits in the partner's capital accounts must be restored. The partnership buys a machine for $210,000 using the $60,000 cash and financing the remaining $150,000 with a recourse debt. How much of the recourse debt is included in Steve's basis?

a. $100,000.
b. $ 90,000.
c. $ 86,000.

30. Assuming there is no partnership minimum gain or mandatory allocation with respect to contributed property, how is nonrecourse debt allocated to the partner’s outside bases?

a. Profits ratios.
b. Loss ratios.
c. Capital account ratios.

Solutions

28. **False is the correct response.** In some cases, such as where a limited partner guarantees a portion of partnership debt, partnership recourse debt may be included in the outside basis of the limited partner.

**True is the incorrect response.** Generally, a limited partner may only increase his basis by his or her share of partnership nonrecourse debt. However, there are special circumstances, such as in the case of loan guarantees, where recourse debt may be included.

29. **"C" is the correct response.** Using the analysis provided in Examples 36 and 37, Steve’s share of recourse debt is $86,000 computed as follows:

<table>
<thead>
<tr>
<th></th>
<th>Steve</th>
<th>Cheryl</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$ 40,000</td>
<td>$ 20,000</td>
</tr>
<tr>
<td>Loss on equipment</td>
<td>(126,000)</td>
<td>(84,000)</td>
</tr>
<tr>
<td>Capital account after liquidation</td>
<td>($86,000)</td>
<td>($64,000)</td>
</tr>
</tbody>
</table>

**"A" is an incorrect response.** $90,000 would be correct if the debt were allocated on the basis of loss ratios – 60% for Steve and 40% for Cheryl.
"C" is an incorrect response. $100,000 would be correct if debt were allocated on the basis of the percentage of capital contributed to the partnership – 66 2/3% for Steve and 33 1/3% for Cheryl.

30. "A" is the correct response. Because no partner bears the economic risk of loss of nonrecourse debt, the theory is that the partnership may walk away from property with nonrecourse debt that is not profitable. On the other hand, if it is generating profits, the partnership will continue to make the nonrecourse debt payments. As a result, nonrecourse debt is allocated to all partners (general and limited) on the basis of the partners’ profits interests. See Example 38.

"B" is an incorrect response. Loss ratios are used in part to determine a partner’s share of recourse debt. See Examples 36 and 37.

"C" is an incorrect response. While capital contributions are used in part to determine a partner’s share of recourse debt, capital ratios are not used in calculating the partner’s share of either recourse or nonrecourse debt.

E. CONCLUDING REMARKS

This course has discussed the tax implications of formation, general reporting procedures of partnership items, and basis determination. The material reflects legislative changes made through the "Middle Class Tax Relief and Job Creation Act of 2012," signed by President Obama on February 22, 2012. Tax planning strategies have been illustrated throughout the course.

Other courses in our “Business Income Tax Series” include Partnership Taxation – Part II, S Corporation Taxation—Part I, and S Corporation Taxation—Part II.
QUIZ QUESTIONS

Place your answers to the following 7 True-False Questions and 23 Multiple Choice Questions on the enclosed answer sheet.

TRUE FALSE QUESTIONS

1. The choice of taxable entity for limited liability companies is made by filing Form 8832.
2. Generally, children who contribute neither capital nor services to a family partnership will not be treated as valid partners by the IRS or courts.
3. With respect to the nonrecognition rules for property transferred to a partnership for a partnership interest, the definition of property includes only tangible assets.
4. Under the proposed regulations dealing with services rendered to a partnership in exchange for a partnership interest, the partnership must recognize gain.
5. In exchange for services rendered, an individual receives a 10% profits interest in the ABC partnership. If the interest is sold within two years, the value of the profits interest must be reported as compensation when it was received.
6. The election of inventory method in computing partnership income is an example of the aggregate concept.
7. A partner’s interest in profits may be different than losses.

MULTIPLE CHOICE QUESTIONS

8. Partner A contributes appreciated business property and Partner B contributes business property that has declined in value to a partnership in exchange for unrestricted partnership interests. What are the immediate tax consequences to the partners?
   a. Partner A – No Gain Recognition; Partner B – No Loss Recognition.
   b. Partner A – No Gain Recognition; Partner B – Loss Recognition.
   c. Partner A – Gain Recognition; Partner B – Loss Recognition.

BASE YOUR ANSWERS TO QUESTIONS 9 AND 10 ON THE FACTS PROVIDED BELOW

During the year, Rich Granger provides accounting services which are noncapital in nature to a real estate partnership. Instead of receiving cash, he received a 10% unrestricted capital interest in the real estate partnership. At the time the interest was transferred, the fair market value and basis of the partnership assets were $500,000 and $300,000 respectively. Assume that the partnership has no debts.

9. What are the tax consequences to Tom as the result of the transfer?
   a. He must recognize $50,000 of capital gain income.
   b. He must recognize $50,000 of ordinary income.
   c. He must recognize $30,000 of ordinary income.
10. Assuming the **proposed regulations do not apply**, what are the tax consequences to the real estate partnership as the result of the transfer?

   a. It must recognize $20,000 of gain for the deemed transfer of property and it has a $50,000 deduction for the services rendered by Tom.

   b. It must recognize $20,000 of gain for the deemed transfer of property and it has a $45,000 deduction for the services rendered by Tom.

   c. It recognizes no gain from partnership interest transfer and it has a $50,000 deduction for the services rendered by Tom.

11. Regarding the Section 83 election to include the value of a **restricted** partnership interest in income at the time of transfer, **which one** of the following statements **is true**?

   a. If the interest is subsequently forfeited, the taxpayer may claim a loss deduction resulting from the forfeiture.

   b. The value of the partnership interest received for services may be discounted for all restrictions, including restrictions that lapse.

   c. One advantage to making the election is to “lock in” the amount of income for services rendered that has to be reported as ordinary income.

12. Partner A transfers $6,000 cash and land valued at $65,000 with a $30,000 basis for a 20% interest in the profits, losses, and capital of the ABC Partnership. The land is encumbered by a $50,000 debt which is assumed by the partnership. Under state law, all partners share in the economic risk of loss of the debt. As a result of the transfer, how much gain does Partner A recognize gain?

   a. $ 4,000.

   b. $10,000.

   c. $14,000.

13. On July 1 of the current year, Andy contributes land with a $90,000 FMV and $60,000 basis for a 50% interest in the ABC partnership. Rachel contributes cash of $60,000 for a 50% interest in the ABC partnership. On September 1, of the current year, Andy receives a $30,000 distribution from the partnership. As a result of the above transaction, how much gain does Andy recognize?

   a. $ -0-.

   b. $10,000.

   c. $30,000.

14. Refer to the facts of question # 13. What is the basis of the land in the hands of the ABC partnership?

   a. $90,000.

   b. $70,000.

   c. $60,000.
15. **Which one** of the following expenditures is **not** considered an organizational expenditure for purposes of the amortization deduction assuming these costs are incurred in the first year of business?

a. Syndication expenses.
b. State filing fees for registering the partnership agreement with the state.
c. Accounting fees related to determining the proper entity choice for tax purposes.

16. ABC corporation incurs $23,000 of qualified organization expenses in 2012 where business began on October 1, 2012 and the corporation reports on a calendar year. Assuming ABC wants to maximize its deductions for 2012, what is the 2012 deduction for organization expenses?

a. $23,000.
b. $5,300.
c. $383.

17. In exchange for a 20% interest in the XYZ Partnership, A contributes (1) cash of $13,000, (2) accounts receivable with a $2,000 fair market value and a zero basis, and (3) land with a $5,000 fair market value and an $8,000 basis. The total value of the partnership is estimated to be $100,000 immediately after A's contribution. What is A's basis in the partnership immediately after A's contribution?

a. $18,000.
b. $20,000.
c. $21,000.

18. Jenny receives a 10% unrestricted interest in XYZ partnership for services rendered to the partnership. The fair market value and basis of the partnership assets are $600,000 and $450,000 respectively. There are no partnership debts. What is Jenny's basis in the partnership immediately after her receipt of her partnership interest?

a. $60,000.
b. $45,000.
c. $0.

19. Steve contributes land with a fair market value of $100,000, a basis of $60,000, and a debt of $20,000 in exchange for a 40% interest in the LMN partnership. According to state law, all partners share in the economic risk of loss of all debts transferred to the partnership. Assuming that there is no other partnership debt at the time of formation, what is Steve's basis in the partnership immediately after his contribution?

a. $60,000.
b. $48,000.
c. $40,000.

20. **Which one** of the following items is **not** separately reported on Schedule K?

a. Dividend income.
b. Charitable contributions.
c. Advertising expense.
21. With respect to property contributions made by the partner to the partnership, for **which one** of the following types of property is the character of the gain or loss (capital or ordinary) determined at the **partnership** level when the partnership sells the property?

a. Capital gain property.

b. Unrealized receivables.

c. Inventory items.

22. The ABC partnership was just formed and it has five partners each owning a 20% interest in the partnership. The partners report their annual taxable income as follows: (1) Partners 1 and 2 – March 31; (2) Partners 3 and 4 – September 30; and (3) Partner 5 – November 30. What is the partnership’s required taxable year and why?

a. Either March 31 or September 30 since these are the months that most (40%) of the partners report their taxable incomes.

b. June 30 since this is half-way between March 31 and September 30 which are the months that most (40%) of the partners report their taxable incomes.

c. Either March 31, September 30, or November 30, depending on which month produces the least aggregate deferral of income.

23. **Which one** of the following satisfies the business purpose requirement for the partnership's reporting on a fiscal year other than its required taxable year?

a. It was suggested by the Natural Business Committee of the American Institute of CPAs.

b. The tax preparer would give the partnership a 25% discount on the tax preparation fee because the fiscal year was at a slow time of the year for the tax preparer.

c. For the last three years, gross receipts recognized in the last two months of each year as a percentage of the three 12-month periods were 30%, 33%, and 27%, respectively.

24. Regarding special allocations, **which one** of the following statements is false?

a. The allocation must affect the partner's capital account.

b. A partnership with two partners may allocate the first $25,000 of capital gain income to Partner A and the first $25,000 of ordinary income to Partner B.

c. Capital accounts must be used in determining the partner's liquidation proceeds.

25. In 2009, Mark Roberts contributed land with a fair market value of $150,000 and a basis of $100,000 for a 40% interest in the ABC Partnership. In August 2012, the partnership sells the land for $190,000. What is Mark’s share of the gain?

a. $66,000.

b. $50,000.

c. $36,000.
26. On the last day of the taxable year, the partnership distributes $50,000 of cash plus $30,000 worth of land to Partner A pursuant to a nonliquidating distribution. The basis of the land (inside basis) is $20,000. The basis of Partner A's interest immediately before the distribution (outside basis) is $45,000. Partner A has not contributed property with a pre-contribution gain. How much gain or loss must Partner A recognize as a result of the distribution?
   a. $35,000.
   b. $25,000.
   c. $ 5,000.

27. On the last day of the taxable year, the partnership distributes $50,000 worth of land to Partner A pursuant to a nonliquidating distribution. The basis of the land (inside basis) is $35,000. The basis of Partner A's interest immediately before the distribution (outside basis) is $30,000. What is the basis of the land in the hands of Partner A (after the distribution)?
   a. $30,000.
   b. $35,000.
   c. $50,000.

28. For the year-ended, a partner’s share of partnership items is as follows: (1) ordinary business income – $20,000; (2) capital gain income – $5,000; (3) tax-exempt interest income – $2,000; and, (4) nondeductible expenses – $1,000. As a result, what is the amount of the net increase in his outside basis?
   a. $25,000.
   b. $26,000.
   c. $20,000.

29. John and Jane form a general partnership by contributing cash of $40,000 and $60,000, respectively. John's share of profit and loss is 30% while Jane's share is 70%. The partnership agreement states that liquidating distributions are made according to the partner's positive capital account balances and any deficits in the partner's capital accounts must be restored. The partnership buys a machine for $300,000 using the $100,000 cash and financing of $200,000 with a recourse debt. How much of the recourse debt is included in John's basis?
   a. $50,000.
   b. $60,000.
   c. $80,000.

30. Charlotte is a limited partner in the ABC limited partnership. She has a 20% interest in profits and a 30% interest in losses. During the year, ABC acquired a nonrecourse mortgage on its building. At the end of the year, the mortgage balance is $1,000,000. Assuming no partnership minimum gain or mandatory allocation with respect to contributed property, how much of the nonrecourse debt is included in Charlotte's basis at year end?
   a. $300,000.
   b. $200,000.
   c. $ -0- .
ENDNOTES

1. Treasury Regulation Section (Reg. Sec.) 301.7701-3(a).
2. Reg. Sec. 301.7701-3(b).
3. Internal Revenue Code Section (IRC Sec.) 761(a).
5. IRC Sec. 761(a).
7. IRC Sec. 721(b).
10. IRC Sec. 704(c)(1).
14. IRC Sec. 83(a).
15. IRC Sec. 83(c)(1).
16. IRC Sec. 83(c)(2).
17. IRC Sec. 83(b)(1).
18. IRC Sec. 83(b)(2).
19. IRC Sec. 83(b)(2).
21. Diamond, 74-1 USTC 9306 (7th Cir. 1974).
25. IRC Secs. 731(a)(1) and 752(a).
27. Reg. Sec. 1.731-1(c)(3).

28. For example, the following cases favored the taxpayer: Otey, 70 TC 312, Aff'd 80-2 USTC 9817 (6th Cir. 1980); Jupiter, 83-1 USTC 9168 (Cl Ct 1983); and Park Realty, 77 TC 412 (1981).

29. IRC Sec. 707(a)(2)(B).


32. Reg. Sec. 1.707-3(c)(1).

33. Reg. Sec. 1.707-3(c)(2).

34. Example 1 of Reg. Sec. 1.707-3(f). Example 14 of the course is based on the regulation example.

35. IRC Sec. 709(b).

36. IRC Sec. 709(b)(2).


40. Reg. Sec. 1.709-2(c).

41. IRC Sec. 1223(1).

42. IRC Sec. 723.

43. IRC Sec. 752(a).

44. IRC Sec. 752(b).

45. Internal Revenue Code Section (IRC Sec.) 702(a).

46. Treasury Regulation Section (Reg. Sec.) 1.702-1(a)(8)(ii).

47. IRC Secs. 702(a)(1) - (a)(6).

48. IRC Sec. 702(b).

49. IRC Secs. 724(a) - (c).

50. IRC Secs. 724(d)(1) and 751(c).

51. IRC Sec. 751(c) and Reg. Sec. 1.751-1(c)(4).

52. IRC Sec. 751(d)(2).

53. IRC Sec. 703(b).

54. IRC Sec. 703(b).
55. IRC Sec. 706(b)(1)(B).
56. IRC Sec. 706(b)(3).
60. The first four reasons were mentioned by the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 (1987, p. 537). The latter four items are contained in Rev. Proc. 87-57, 1987-2 CB 687.
63. IRC Sec. 444(b)(2).
64. IRC Sec. 444(b)(4).
65. Reg. Sec. 1.444-3T(b)(1).
67. IRC Sec. 704(a).
68. IRC Sec. 704(b).
69. IRC Sec. 704(b)(2).
73. IRC Sec. 704(c)(1)(A).
74. IRC Sec. 733(1).
75. IRC Sec. 731(a)(1).
77. IRC Sec. 733(2).
78. IRC Sec. 732(a)(1).
79. IRC Sec. 732(a)(2).
80. IRC Sec. 732(c).
81. IRC Secs. 737(c)(1), 731(c) and 737(e).
82. IRC Sec. 731(c)(3)(B).
83. IRC Sec. 751(b)(1).
84. IRC Secs. 705(a)(1)(A) and (B).
85. IRC Secs. 705(a)(2)(A) and (B).
87. Reg. Sec. 1.752-1T(a)(1)(iii) and, to some extent, Reg. Secs. 1.752-2(b)(3)(i) and 1.752-2(f), Example 5.
88. Reg. Secs. 1.752-1(a)(1) and 1.752-1T(a)(1)(i).
89. Reg. Sec. 1.752-2(b)(1).
90. Reg. Sec. 1.752-1(a)(2).
91. IRC Sec. 752(a) and Reg. Sec. 1.752-1(b).
92. Reg. Sec. 1.752-2(b)(3).
94. Reg. Secs. 1.752-2(b)(1) and 1.752-1T(d)(3)(i).
95. Reg. Secs. 1.752-3(a) and 1.752-1T(e)(3)(ii).
96. Reg. Secs. 1.752-3(a)(1) and (a)(2) and 1.752-1T(e)(1)(i) and (ii).
97. IRC Sec. 752(b) and Reg. Sec. 1.752-1(c).