T65T10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's

1065 Deskbook

THOMSON REUTERS™

Fort Worth, Texas
(800) 431-9025
trainingcpe.thomson.com

T65T10

Copyright 2010 Thomson Reuters/PPC
All Rights Reserved

This material, or parts thereof, may not be reproduced in another document or manuscript in any form without the permission of the publisher.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.—*From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers and Associations.*

The following are registered trademarks filed with the United States Patent and Trademark Office:

Checkpoint® Tools
PPC's *Practice Aids* ™
PPC's *Workpapers* ™
PPC's *Engagement Letter Generator* ™
PPC's *Interactive Disclosure Libraries* ™
PPC's *SMART Practice Aids* ™

NATIONAL REGISTRY OF CPE SPONSORS

Practitioners Publishing Company is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Website: **www.nasba.org**.

QAS QUALITY ASSURANCE SERVICE

Practitioners Publishing Company is registered with the National Association of State Boards of Accountancy (NASBA) as a Quality Assurance Service (QAS) sponsor of continuing professional education. State boards of accountancy have final authority on acceptance of individual courses for CPE credit. Complaints regarding QAS program sponsors may be addressed to NASBA, 150 Fourth Avenue North, Suite 700, Nashville, TN 37219-2417. Website: **www.nasba.org**.

Registration Numbers

Texas	001615
New York	001076
NASBA Registry	103166
NASBA QAS	006

Interactive Self-study CPE

Companion to PPC's 1065 Deskbook

TABLE OF CONTENTS

	Page
COURSE 1: BASIS AND ALLOCATIONS	
Overview	1
Lesson 1: Basis in the Partnership Interest and Partnership Liabilities	3
Lesson 2: When FMV and Basis of Contributed Property Differ—Section 704(c) Allocations	81
Glossary	127
Index	129
COURSE 2: ADMINISTRATIVE MATTERS	
Overview	131
Lesson 1: Selecting the Tax Year	133
Lesson 2: Accounting Methods	157
Lesson 3: Partnership Tax Elections	187
Lesson 4: The TMP, Amended Returns, and Due Diligence in Form 1065 Preparation	209
Glossary	241
Index	243

To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS	
Course 1: Testing Instructions for Examination for CPE Credit	245
Course 1: Examination for CPE Credit Answer Sheet	247
Course 1: Self-study Course Evaluation	248
Course 2: Testing Instructions for Examination for CPE Credit	249
Course 2: Examination for CPE Credit Answer Sheet	251
Course 2: Self-study Course Evaluation	252

INTRODUCTION

Companion to PPC's 1065 Deskbook consists of two interactive self-study CPE courses. These are companion courses to *PPC's 1065 Deskbook* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **cl.thomsonreuters.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of partnerships and Form 1065. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

Qualifying Credit Hours—QAS or Registry

PPC is registered with the National Association of State Boards of Accountancy as a sponsor of continuing professional education on the National Registry of CPE Sponsors (Registry) and as a Quality Assurance Service (QAS) sponsor. Part of the requirements for both Registry and QAS membership include conforming to the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the standards). The standards were developed jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the standards. Each course is designed to comply with the standards. For states adopting the standards, recognizing QAS hours or Registry hours, credit hours are measured in 50-minute contact hours. Some states, however, require 100-minute contact hours for self study. Your state licensing board has final authority on accepting Registry hours, QAS hours, or hours under the standards. Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program or have adopted the standards and allow QAS CPE credit hours. Alternatively, you may visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours or have adopted the standards. Credit hours for CPE courses vary in length. Credit hours for each course are listed on the "Overview" page before each course.

CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the Test Instructions preceding the Examination for CPE Credit Answer Sheet. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

Print Grading. You can receive CPE credit by mailing or faxing your completed Examination for CPE Credit Answer Sheet to the Tax & Accounting business of Thomson Reuters for grading. Answer sheets are located at the end of all course materials. Answer sheets may be printed from electronic products. The answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for each course. Payment of $79 (by check or credit card) must accompany each answer sheet submitted. We cannot process answer sheets that do not include payment. Please take a few minutes to complete the Course Evaluation so that we can provide you with the best possible CPE.

You may fax your completed **Examination for CPE Credit Answer Sheet** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet.** Payment of $79 must accompany each answer sheet submitted. We would also appreciate a separate **Course Evaluation** from each person who completes an examination.

Express Grading. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your Examination for CPE Credit Answer Sheet. Expedited grading requests will be accepted by fax only if accompanied with credit card information. Please fax express grading to the Tax & Accounting business of Thomson Reuters at (817) 252-4021.

Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion.* You should retain it and a copy of these materials for at least five years.

PPC In-House Training

A number of in-house training classes are available that provide up to eight hours of CPE credit. Please call our Sales Department at (800) 431-9025 for more information.

COMPANION TO PPC'S 1065 DESKBOOK

COURSE 1

Basis and Allocations (T65TG101)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses basis and allocations. Lesson 1 discusses the basis in the partnership interest and partnerships and a partner's basis from partnership liabilities. Lesson 2 explains when FMV and basis of contributed property differ—Section 704(c) allocations.
PUBLICATION/REVISION DATE:	November 2010
RECOMMENDED FOR:	Users of *PPC's 1065 Deskbook*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of tax preparation for partnerships
CPE CREDIT:	8 QAS Hours, 8 Registry Hours 8 CTEC Federal Hours, 0 CTEC California Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours. **Enrolled Agents:** This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).
FIELD OF STUDY:	Taxes
EXPIRATION DATE:	Postmark by **November 30, 2011**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Basis in the Partnership Interest and Partnership Liabilities

Completion of this lesson will enable you to:
- Identify and calculate inside and outside basis.
- Allocate liabilities to partners.
- Describe how to handle guarantees and similar arrangements and apply the regulations on liability assumptions.

Lesson 2—When FMV and Basis of Contributed Property Differ—Section 704(c) Allocations

Completion of this lesson will enable you to:
- Identify the permissible Section 704(c) allocation methods.
- Describe how to allocate gain/loss on dispositions of partnership property.
- Determine how to allocate depreciation and gains/losses under IRC Sec. 704(c) and the ceiling rule and reverse Section 704(c) allocation.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

> **Thomson Reuters**
> **Tax & Accounting—R&G**
> **T65TG101 Self-study CPE**
> **36786 Treasury Center**
> **Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Basis in the Partnership Interest and Partnership Liabilities

Introduction

A taxpayer's tax basis in a partnership interest (often called the partner's *outside basis*) is important for the same reasons basis is important with respect to any property. It represents the partner's *cost* for tax purposes and issued to measure the taxable gain or loss upon disposition of the partnership interest. In addition, a partner's outside basis can (1) limit the partner's ability to deduct a partnership loss; (2) cause a cash distribution to be taxable instead of tax free; and (3) affect the basis of property received as a distribution. This course deals strictly with a partner's outside basis in the partnership interest. This must be distinguished from the partnership's adjusted basis in partnership assets (often referred to as *inside basis*).

In simple arrangements, inside basis and the total outside basis of all the partners may be the same, but this is not necessarily the case. Each partner's outside basis can be affected by certain distributions and transfers of partnership interests. These events would not necessarily affect the partnership's inside basis in its assets.

Subject to several important exceptions, the aggregate of all the partners' adjusted bases in their partnership interests (total outside basis) will equal the adjusted basis of the partnership's assets (inside basis). This balance of inside and outside basis is the key to understanding partnership accounting problems.

This lesson explains the critically important rules for allocating basis from partnership liabilities to partnership interests. These rules, under IRC Sec. 752, were significantly different before the release of temporary and final regulations in 1988, 1989, and 1991. Some partnerships may still have some debt that must be allocated using the *old* rules (before the issuance of the temporary and final regulations), but most debt must be allocated using the *new* rules. The effective dates for the *new* rules are also covered in this lesson.

Under IRC Sec. 752:

1. an *increase* in a partner's share of partnership liabilities (or in a partner's personal liabilities because of the assumption of partnership liabilities) is treated as a *constructive cash contribution* by the partner to the partnership, for purposes of determining the partner's basis in the partnership interest (often called *outside basis*), and

2. a *decrease* in a partner's share of partnership liabilities (or in a partner's personal liabilities because of the partnership's assumption of such liabilities) is treated for purposes of determining the partner's basis in the partnership interest as a *constructive cash distribution* by the partnership to the partner.

Under corresponding rules, IRC Secs. 722 and 733 provide that a partner's basis in his partnership interest (outside basis) is increased by contributions of money and decreased (but not below zero) by distributions of money. Thus, increases and decreases in a partner's allocation of partnership liabilities have the same effects on outside basis as actual cash contributions and distributions. To the extent a partner receives an actual or constructive distribution of money in excess of his basis in the partnership interest, the partner must recognize gain.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify and calculate inside and outside basis.
- Allocate liabilities to partners.
- Describe how to handle guarantees and similar arrangements and apply the regulations on liability assumptions.

The Three Exceptions to the Rule of the Equality of Inside and Outside Basis

Subject to several exceptions, the aggregate of all the partners' adjusted bases in their partnership interests (total outside basis) will equal the adjusted basis of the partnership's assets (inside basis).

Perhaps there are three most common exceptions to the general rule of equality of inside and outside basis:

1. When there has been an acquisition of a partnership interest other than by contribution (i.e., sale or exchange of a partnership interest or inheritance of a partnership interest). When a partner acquires a partnership interest by purchasing it from another partner or inheriting the interest, there may be a discrepancy between the acquiring partner's outside basis and his or her share of inside basis. The acquiring partner's outside basis is equal to either his or her cost (in the case of a purchase) or the partnership interest's fair market value on the date of the decedent partner's death (in the case of an inherited interest). The partnership's inside basis is not adjusted to reflect the acquiring partner's new outside basis unless the partnership makes an election under IRC Sec. 754 or a mandatory basis adjustment is required for property with a substantial built-in loss.

2. When gain or loss is recognized by a partner on a distribution.

   a. A partner recognizes gain on a distribution if the partner receives money or certain marketable securities in excess of his or her outside basis. Consequently, the partnership's inside basis decreases by more than the decrease in the partner's outside basis, creating an imbalance. For example, if the partnership distributes $100 to a partner when his or her outside basis is only $70, the partner realizes a $30 gain. Although the inside basis in partnership property has decreased by $100, the partner's outside basis in his or her interest has only decreased by $70 because a partner's outside basis cannot be reduced below zero.

   b. Similarly, when a partner recognizes a loss on a distribution (which can only happen upon the liquidation of the partner's interest). The partner's outside basis decreases at a time when there is no corresponding decrease in the partnership's inside basis. For example, if the partnership distributes $30 cash in a liquidating distribution to a partner who has an outside basis of $50, inside basis decreases by $30, while outside basis decreases by $50, and the partner recognizes a $20 loss.

   In either of these cases, the imbalance does not occur if the partnership has a Section 754 election in effect, which requires an adjustment to the basis of the partnership's assets, or if a mandatory basis adjustment is required because of a substantial basis reduction.

3. When there has been a decrease in basis of a partnership asset on a current distribution or an increase or decrease in basis of a partnership asset on a liquidating distribution [excluding application of IRC Sec. 732(d)]. In some circumstances when an asset is distributed from a partnership to a partner, the asset's basis in the distributee partner's hands immediately after the distribution is different than the basis of that asset to the partnership immediately before the distribution. When this occurs, the partnership's inside basis changes by an amount different than the distributee partner's outside basis. For example, if a partnership distributes equipment with a $50 inside basis to a partner whose outside basis is only $30, the basis of that asset in the partner's hands is only $30 after the distribution. The asset has lost $20 in basis. The imbalance does not occur if the partnership has a Section 754 election in effect, which requires an adjustment to the basis of the partnership's assets or if a mandatory basis adjustment is required because of a substantial basis reduction.

Knowing When Temporary Basis Imbalances Occur

There is a possible temporary imbalance between inside and outside basis in two other situations:

1. When there has been a loss limitation under IRC Sec. 704(d) because of the partner's lack of outside basis.

2. When the partnership is holding assets (usually cash), and the tax treatment of such assets is being held in abeyance pending completion of a transaction.

The classic example of the situation is when a partnership receives a payment for an option. The partnership holds cash, which obviously has inside basis. But the receipt of the cash has not yet been taken into income by the partnership, either as part of the proceeds from the sale of the optioned property or as income from the expiration of the option.

These temporary imbalances are automatically reconciled when the second leg of the applicable transaction occurs. For example, when a temporary imbalance is created by a loss limitation under IRC Sec. 704(d), the imbalance between inside and outside basis is eliminated when the partner's outside basis is subsequently increased such that the loss becomes deductible. On the other hand, the three permanent exceptions discussed earlier require timely Section 754 elections to rebalance inside and outside basis. Temporary imbalances cannot be rebalanced by making elections.

Rebalancing Inside and Outside Basis

The three exceptions to the general rule that inside basis equals outside basis are occasions on which the special optional basis adjustment election can be made under IRC Sec. 754. Effectively, the Section 754 election is intended to rebalance inside and outside basis after one of these three exceptions occurs. If the partnership makes an election, it is required to adjust the inside basis of the partnership assets to restore the balance of inside and outside basis.

In some cases, a Section 743 or 734 basis adjustment may be mandatory (these are the Code sections that govern the optional basis adjustment resulting from a Section 754 election). If the partnership is not an electing investment partnership or a securitization partnership and there is a substantial built-in loss (i.e., the partnership's adjusted basis in its property exceeds by more than $250,000 the FMV of the partnership property), a basis adjustment is mandatory on the transfer of an interest in the partnership. A mandatory basis adjustment must be made on a distribution if there is a substantial basis reduction (a downward adjustment of more than $250,000 would be made to the basis of partnership assets if a Section 754 election were in effect) and the partnership is not a securitization partnership.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. There are three exceptions to the fundamental rule of equality of inside and outside basis. One of those exceptions includes which of the following?

    a. When the partnership interest has been acquired by contribution.

    b. When the partnership interest has been acquired by inheritance.

    c. When a partnership asset basis is increased on a current distribution.

2. A partnership distributes a liquidating distribution to a partner. The distribution is $50 cash, and the partner's outside basis was $60. As a result of this distribution, which of the following will happen?

    a. The inside basis increases by $50, and outside basis increases $50.

    b. The inside basis increases by $60, and outside basis decreases $50.

    c. The inside basis decreases by $50, and outside basis decreases $60.

    d. The inside basis decreases by $60, and outside basis decreases $50.

3. XYZ Partnership is considering the transfer of an interest in the partnership. XYZ Partnership is not a securitization partnership. In which of the following situations is a basis adjustment mandatory?

    a. The XYZ partnership's adjusted basis in its property exceeds the FMV of the property by more than $250,000.

    b. The partnership's adjusted basis in its property exceeds the FMV of the property by no more than $250,000.

    c. The partnership's adjusted basis in its property does not exceed the FMV of the property.

    d. The partnership's adjusted basis in its property qualifies under IRC Sec. 179.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. There are three exceptions to the fundamental rule of equality of inside and outside basis. One of those exceptions includes which of the following? **(Page 4)**

   a. When the partnership interest has been acquired by contribution. [This answer is incorrect. The general rule in IRC Sec. 723 is that the basis of a partnership interest acquired in exchange for a property contribution is the partner's adjusted tax basis in the contributed property. The inside and outside basis are the same. An exception applies when the interest is acquired by other than contribution.]

   b. When the partnership interest has been acquired by inheritance. [This answer is correct. When a partner acquires a partnership interest by inheriting the interest, there may be a discrepancy between the acquiring partner's outside basis and his or her share of inside basis. The acquiring partner's outside basis is equal to the partnership interest's fair market value on the date of the decedent partner's death.]

   c. When a partnership asset basis is increased on a current distribution. [This answer is incorrect. When an asset is distributed from a partnership to a partner, the asset's basis in the distributed partner's hands immediately after the distribution is different than the basis of that asset to the partnership immediately before the distribution. When this occurs, the partnership's inside basis changes by an amount different than the distribute partner's outside basis.]

2. A partnership distributes a liquidating distribution to a partner. The distribution is $50 cash, and the partner's outside basis was $60. As a result of this distribution, which of the following will happen? **(Page 4)**

   a. The inside basis increases by $50, and outside basis increases $50. [This answer is incorrect. This answer choice does not correctly reflect the effect on inside or outside basis because a liquidation event reduces that partner's basis, not increases it, and the impact on inside and outside basis are not necessarily equal in a liquidation event.]

   b. The inside basis increases by $60, and outside basis decreases $50. [This answer is incorrect. Inside basis is decreased by the distribution, not increased.]

   c. The inside basis decreases by $50, and outside basis decreases $60. [This answer is correct. In a liquidating distribution, inside basis decreases by the amount of the distribution, and outside basis decreases by the remaining basis, and in this example, results in a recognized loss to the partner.]

   d. The inside basis decreases by $60, and outside basis decreases $50. [This answer is incorrect. This answer choice does not correctly reflect the calculated amount of decrease to the inside and outside basis.]

3. XYZ Partnership is considering the transfer of an interest in the partnership. XYZ Partnership is not a securitization partnership. In which of the following situations is a basis adjustment mandatory? **(Page 4)**

   a. The XYZ partnership's adjusted basis in its property exceeds the FMV of the property by more than $250,000. [This answer is correct. A mandatory basis adjustment is required for transfer of an interest in the partnership with a substantial built-in loss.]

   b. The partnership's adjusted basis in its property exceeds the FMV of the property by no more than $250,000. [This answer is incorrect. This answer choice does not properly reflect the dollar limit governing a mandatory basis adjustment.]

   c. The partnership's adjusted basis in its property does not exceed the FMV of the property. [This answer is incorrect. Mandatory basis adjustment occurs for transfer of a partnership when the partnership's adjusted basis in its property exceeds FMV of the property by a specified dollar amount.]

   d. The partnership's adjusted basis in its property qualifies under IRC Sec. 179. [This answer is incorrect. IRC Sec. 179 pertains to depreciation of property, not to mandatory basis adjustment.]

Determining Initial Outside Basis When No Liabilities Are Involved

When a partnership interest is acquired for a direct partnership contribution and no liabilities are involved, the partner's initial basis (under IRC Secs. 705 and 722) equals the sum of:

1. the amount of money contributed, plus
2. the adjusted basis of property contributed (i.e., a *substituted basis* concept applies), plus
3. the taxable income recognized from a contribution of services, if any, plus
4. the gain recognized because of the investment company rule of IRC Sec. 721(b) (if any).

Example 1B-1 Partners contribute only cash.

Denise and Lisa each contribute $5,000 to form Roman Shopper Co., a general partnership. In this case, each partner's initial outside basis is equal to the money contributed. Denise and Lisa each have a $5,000 initial basis in their respective partnership interests.

Example 1B-2 Partners contribute cash and property.

Assume the same facts as in Example 1B-1, except, instead of cash, Lisa contributes a computer, software, and other office equipment with a $5,000 FMV and a $3,000 adjusted tax basis. Again, Denise would have a $5,000 basis in her partnership interest, but Lisa's basis is only $3,000—her adjusted basis in the contributed property. The partnership's basis in the property is $3,000.

There are times when a partner acquires a partnership interest in exchange for services rendered to the partnership. If the partner recognizes taxable compensation income for the services, the partner's initial basis equals the compensation income recognized. However, a partner receiving a profits-only interest in exchange for services will not recognize income, nor will the partnership deduct any amount as partner compensation. There are three exceptions to this general rule. The partner recognizes income if:

- the profits interest relates to a substantially certain and predictable stream of income from partnership assets (high quality debt securities or a good net lease);
- the partner disposes of the profits interest within two years of receiving it; or,
- the profits interest is a limited partner interest in a publicly traded partnership.

This is the same result as if the partnership paid for the services and the service partner simultaneously exchanged the payment for a partnership interest.

Rev. Proc. 93-27 was clarified by Rev. Proc. 2001-43. Under the clarification, a partner will be treated as receiving a profits-only interest that is substantially nonvested on the date the interest is granted, provided that the partner receiving the interest is treated as the owner of the interest and recognizes the income associated with the interest for the period from the date of the grant forward. Additionally, neither the partnership nor any of the partners can deduct any amount at any time for the fair market value of the profits-only interest.

Example 1B-3 Partner contributes services.

In the second year of the partnership (described in Example 1B-2), Rita is admitted as an equal partner in exchange for services (that are not required to be capitalized) valued at $6,000. At that time, the FMV of partnership property was $18,000. Rita reports $6,000 as income (compensation for services) resulting in an initial $6,000 outside basis in her partnership interest. The partnership claims a $6,000 deduction for compensation expense that should be specially allocated to Denise and Lisa ($3,000 each). The partnership's tax-basis balance sheet before and after Rita's admission is as follows:

	Before Rita's Admission Dr. (Cr.)	Entries to Record Rita's Services Dr. (Cr.)	Ending Balance Dr. (Cr.)
Cash	$ 8,000		$ 8,000
Other assets	10,000		10,000
Total assets	$ 18,000		$ 18,000
Capital:			
Denise	$ (9,000)	$ 3,000	$ (6,000)
Lisa	(9,000)	3,000	(6,000)
Rita	—	(6,000)	(6,000)
Total capital	$ (18,000)	$ -0-	$ (18,000)

Outside Basis of Transferred Partnership Interest

When a partner purchases a partnership interest from another partner or acquires it by gift, bequest, or other transfer, the partner's initial outside basis is determined under IRC Sec. 742. For example, when a partnership interest is purchased from an existing partner, the transferee's purchase price becomes the initial outside basis. When a partnership interest is acquired by gift, the transferee's basis generally equals the donor's basis. The basis of an inherited partnership interest, for years other than 2010, equals the FMV of the partnership interest at the decedent's date-of-death or the alternate valuation date, if applicable. For property inherited from a decedent dying in 2010, a modified carryover basis system applies.

Example 1B-4 Partner purchases interest from another partner.

After Rita has been a partner in Roman Shopper Co. for two years, she sells her partnership interest to John for $8,000. John's initial basis in his partnership interest is $8,000—his purchase price. John's initial basis is determined without reference to his share of the partnership's basis in its assets. John may want the partnership to make an election to adjust the basis of its assets to reflect his purchase price. If the partnership makes the election under IRC Sec. 754, the transferee partner's (John's) proportionate share of partnership assets will be stepped up. Thus, John's share of any income arising from the subsequent sale of the assets is reduced by the step-up amount.

Rita's partnership interest basis for determining gain or loss from the sale to John is equal to her initial basis plus the cumulative adjustments for her share of partnership activity during the time she was a partner.

Deficit Restoration Obligation

Some partnership agreements may include deficit restoration obligation (DRO) provisions to comply with the Section 704(b) substantial economic effect rules for purposes of allocating partnership income, gains, deductions, and losses. When a DRO applies to a partner, that partner is obligated to make a contribution to eliminate any negative capital account that may exist upon liquidation of the partnership. In and of itself, a DRO does not result in any additional basis for the affected partner. However, if a limited partner has a partial DRO (an obligation to restore part of a negative capital account upon liquidation of the partnership), that limited partner can be allocated outside basis from debt, under the Section 752 rules, from partnership recourse debt up to the amount of the partial DRO.

Staged Pay-in Arrangements

Occasionally a partner agrees to make contributions in installments or pursuant to a promissory note owed to the partnership. (This arrangement is sometimes called a *staged pay-in* or *multiyear pay-in*.) In such cases, the partner's basis generally is increased only as the contribution obligation is fulfilled.

Example 1B-5 Deferred partner contributions (staged pay-ins).

Tim and Jeff form a partnership which they intend to own equally to build homes. Tim contributes $120,000 and Jeff contributes $20,000 and a $100,000 personal staged pay-in note. The note bears a market interest rate but does not have fixed principal payment dates. Jeff intends to pay off the note over four years. In Year 2, Jeff reduces his contribution obligation by $25,000 by paying that amount of cash to the partnership.

Tim's initial outside basis is $120,000. Jeff's initial outside basis is only $20,000—his cash contribution. Jeff has no additional partnership outside basis as a result of his staged pay-in note. His basis increases only as he actually makes payments to reduce the note's principal balance. Thus, Jeff's basis increases by $25,000 in Year 2.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Two individuals agree to form a partnership. There are no liabilities involved. One contributes $3,000, the other contributes property with a FMV of $3,000 and an adjusted basis of $2,500. What is the basis of each partner?

    a. The cash contributor has a $3,000 basis, and the property contributor has $3,000 basis.

    b. The cash contributor has a $2,500 basis, and the property contributor has $2,500 basis.

    c. The cash contributor has a $3,000 basis, and the property contributor has $2,500 basis.

5. Which of the following is **not** considered in the partner's initial basis when a partnership interest is acquired for direct partnership contribution and no liabilities are involved?

    a. The gain recognized due to IRS Sec. 721(b).

    b. The taxable income resulting from the contribution of property.

    c. The contributed property's adjusted basis.

    d. The cash contributed by the partner.

6. When a partnership basis is acquired as result of a gift, what is the new partner's basis?

    a. The same as the basis of the donor, generally.

    b. The FMV of the interest at date of the gift.

    c. The new partner's basis becomes the initial outside basis.

7. Which of the following is the initial basis of a partner who purchases the partnership interest of an existing partner?

    a. The same as the basis of the partner from whom the interest was purchased.

    b. The proportionate share of the total assets of the partnership.

    c. Is determined without reference to share of partnership basis.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Two individuals agree to form a partnership. There are no liabilities involved. One contributes $3,000, the other contributes property with a FMV of $3,000 and an adjusted basis of $2,500. What is the basis of each partner? **(Page 9)**

   a. The cash contributor has a $3,000 basis, and the property contributor has a $3,000 basis. [This answer is incorrect. Per IRC Sec. 705 and 722, the partner who contributed property would have an initial basis equal to the adjusted basis of the property contributed.]

   b. The cash contributor has a $2,500 basis, and the property contributor has a $2,500 basis. [This answer is incorrect. The cash contributor's basis is the cash contributed per IRC Sec. 705 and 722.]

   c. The cash contributor has a $3,000 basis, and the property contributor has a $2,500 basis. [This answer is correct. In accordance with 705 and 722, when a partnership interest is acquired for a direct partnership contribution and no liabilities are involved, the partner's initial basis equals the sum of the amount of money contributed, plus the adjusted basis of property contributed, plus the taxable income recognized from a contribution of services, if any, plus (minus) the gain (loss) recognized because of the investment company. The cash contributor's basis is the cash contributed, and the property contributor's basis is the adjusted basis in the property.]

5. Which of the following is **not** considered in the partner's initial basis when a partnership interest is acquired for direct partnership contribution and no liabilities are involved? **(Page 9)**

   a. The gain recognized due to IRS Sec. 721 (b). [This answer is incorrect. When calculating the partnership interest, the gain recognized because of the investment company rule of IRS Sec 721(b), if there is any, due to the IRS code.]

   b. The taxable income resulting from the contribution of property. [This answer is correct. The partnership's initial basis when a partnership interest is acquired and when no liabilities are involved is the sum of the taxable income recognized from a contribution of services, not a contribution of property according to IRS code.]

   c. The contributed property's adjusted basis. [This answer is incorrect. The partner's initial basis, under IRS Secs. 705 and 722 do include the sum of the adjusted basis of the property contributed.]

   d. The cash contributed by the partner. [This answer is incorrect. To calculate the partner's initial basis, the amount of money contributed by the partner would be added under the IRS code.]

6. When a partnership basis is acquired as result of a gift, what is the new partner's basis? **(Page 9)**

   a. The same as the basis of the donor, generally. [This answer is correct. Per IRC Sec. 742, generally, the basis of the interest in the hands of the donee is the same as that of the donor.]

   b. The FMV of the interest at date of the gift. [This answer is incorrect. The basis of the gift is not FMV. The basis of an inherited partnership equals the FMV of the partnership interest at the decedent's date-of-death or the alternate valuation date, if applicable, but not when the partnership basis was acquired as a result of a gift.]

   c. The new partner's basis becomes the initial outside basis. [This answer is incorrect. When a partnership interest is purchased from an existing partner, then the transferee's purchase price becomes the initial outside basis, but not when the partnership basis was acquired as a result of a gift.]

7. Which of the following is the initial basis of a partner who purchases the partnership interest of an existing partner? **(Page 9)**

   a. The same as the basis of the partner from whom the interest was purchased. [This answer is incorrect. Whenever a partnership interest is purchased, the basis may not remain the same as it was in the hands of the seller, and will be determined based on the transferee's purchase-price.]

   b. The proportionate share of the total assets of the partnership. [This answer is incorrect. In the case of a sale of partnership interests, the basis of the share of partnership's basis in assets is not used to calculate the basis of the new owner. Per IRC Sec 742, the transferee's purchase price becomes the initial outside basis.]

   c. Is determined without reference to share of partnership basis. [This answer is correct. Initial basis is determined without reference to share of partnership's basis in assets. The initial basis of a purchased partnership interest is the purchase price per IRC Sec. 742.]

How Liabilities Affect Initial Outside Basis

A partner treats an increase in his or her share of the partnership's liabilities as a deemed cash contribution increasing his or her outside basis in the partnership interest. A decrease in a partner's share of the partnership's liabilities is treated as a deemed distribution of money decreasing the partner's outside basis. Therefore, relief of indebtedness or assumption of indebtedness affects the partner's initial outside basis. Essentially, the contributing partner's basis is increased by any net assumption of liabilities or decreased by any net relief from liabilities.

Example 1C-1 Initial basis when partner contributes liabilities.

Tim and Jeff form an equal partnership to construct a luxury duplex. Tim contributes $100,000. Jeff contributes $50,000 and raw land worth $110,000. The land is subject to a $60,000 mortgage and was purchased for $75,000, which is its adjusted basis on the contribution date. Each partner's initial outside basis in the partnership is calculated as follows:

	Tim Dr. (Cr.)	Jeff Dr. (Cr.)
Cash contribution	$ 100,000	$ 50,000
Real estate contribution	—	75,000
Liabilities assumed by the partnership	—	(60,000)
Prorata share of partnership liabilities	30,000	30,000
Initial outside basis	$ 130,000	$ 95,000

Contingent Liabilities in Basis

The IRS has aggressively pursued transactions involving claims that contingent liabilities do not reduce the basis a partner has in a partnership interest. The typical transaction involves the transfer of cash and other assets to a partnership. The partnership then assumes contingent business liabilities that are transferred along with the assets. For example, potential future asbestos liabilities, health care liabilities, or other contingent liabilities could be transferred to the partnership. However, since these liabilities are contingent liabilities, they would not reduce the basis of the contributing partner's interest in the partnership. Thus, the partner usually argues that he or she has a high basis in his or her partnership interest, which generates a loss on sale of the interest, since the buyer would consider the risk of having to pay the contingent liabilities in setting a sale price.

Treasury issued regulations trying to close down this strategy by classifying both fixed and contingent obligations as liabilities for this purpose, whether or not the obligation is otherwise taken into account for purposes of the Internal Revenue Code.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. A and B form an equal partnership. A contributes $10,000, and B contributes $5,000 and land with FMV and adjusted basis of $7,500. The land is subject to a $6,000 mortgage. What is the initial outside basis of B?

   a. $5,000.

   b. $7,500.

   c. $9,500.

   d. $12,500.

9. A and B form an equal partnership. A contributes $1,000, and B contributes $500 and land with FMV and adjusted basis of $850. The land is subject to a $600 mortgage. What is the initial outside basis of A?

   a. $700.

   b. $1,000.

   c. $1,050.

   d. $1,300.

10. Contingent liabilities, such as potential asbestos liabilities, create problems in determining appropriate basis because of which of the following?

    a. Contingent liabilities reduce the basis in the contributing partner's interest.

    b. Assets contributed by a partner are discounted by the amount of the contingent liabilities associated with those assets.

    c. Contingent liabilities should add to the value of assets contributed.

    d. Initial outside basis is not discounted by contingent liabilities.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

8. A and B form an equal partnership. A contributes $10,000, and B contributes $5,000 and land with FMV and adjusted basis of $7,500. The land is subject to a $6,000 mortgage. What is the initial outside basis of B? **(Page 16)**

   a. $5,000. [This answer is incorrect. It does not consider the value of the land contributed.]

   b. $7,500. [This answer is incorrect. It does not consider the value of the cash contributed, nor the mortgage on the contributed property.]

   c. $9,500. [This answer is correct. Basis is cash plus FMV of property less mortgage on contributed property plus a prorata share of liabilities assumed by the partnership.]

   d. $12,500. [This answer is incorrect. It does not consider the mortgage on the land contributed.]

9. A and B form an equal partnership. A contributes $1,000, and B contributes $500 and land with FMV and adjusted basis of $850. The land is subject to a $600 mortgage. What is the initial outside basis of A? **(Page 16)**

   a. $700. [This answer is incorrect. Allocated liabilities should increase a partner's basis, not reduce it.]

   b. $1,000. [This answer is incorrect. It considers the value of the cash contributed, but not the other elements of Partner B's basis.]

   c. $1,050. [This answer is incorrect. This is the outside basis of Partner B.]

   d. $1,300. [This answer is correct. Basis is cash plus a share of the liabilities for Partner A allocated pro-rata.]

10. Contingent liabilities, such as potential asbestos liabilities, create problems in determining appropriate basis because of which of the following? **(Page 16)**

    a. Contingent liabilities reduce the basis in the contributing partner's interest. [This answer is incorrect. Contingency liabilities do not reduce the contributing partner's interest because, if the partner sold his interest, the buyer would consider the risk of having to pay the contingent liabilities in setting a sales price.]

    b. Assets contributed by a partner are discounted by the amount of the contingent liabilities associated with those assets. [This answer is incorrect. Contributed assets are not discounted because they may be considered by subsequent potential buyers of the assets.]

    c. Contingent liabilities should add to the value of assets contributed. [This answer is incorrect. Contingent liabilities should detract from the value of assets contributed because a potential buyer would consider the risk of having to pay the liability in the future.]

    d. Initial outside basis is not discounted by contingent liabilities. [This answer is correct. The partner's initial outside basis is not discounted, because the liabilities have not yet been incurred.]

How to Adjust a Partner's Initial Outside Basis

A partner's initial outside basis is adjusted (under IRC Sec. 705) to reflect subsequent allocations of partnership items. Ordinarily, basis calculations are made at year-end. However, certain events require a basis calculation at interim dates.

Basis is increased to reflect the following:

1. Additional contributions of money (including *deemed* cash contributions equal to the partner's share of partnership debt), property, or taxable services.

2. The partner's share of taxable partnership income.

3. The partner's share of tax-exempt partnership income. This ensures that tax-exempt income is not taxed when it is earned, when it is distributed, or when it is reflected in a higher sale price for the partnership interest when the interest is sold.

4. The partner's share of percentage depletion deductions exceeding the adjusted basis in depletable property. This addback prevents depletion deductions in excess of depletable property basis from reducing the partner's outside basis.

Basis is decreased, but not below zero, to reflect the following:

1. Money distributed (including *deemed* cash distributions equal to the partner's share of reductions in partnership debt) and the basis of any property distributed.

2. The partner's share of partnership losses, including capital losses.

3. The partner's share of expenditures that, for income tax purposes, are neither deductible nor capitalizable.

4. The partner's share of depletion from oil and gas properties.

The impact of partnership liabilities on a partner's basis is discussed later in this lesson.

The regulations do not discuss the basis-reducing items included in number 3. Some items typically encountered include nondeductible life insurance premiums, expenses associated with producing tax-exempt income, losses disallowed under the Section 267 related-party rules, the 50% disallowance of meal and entertainment expenses, and political contributions. If a life insurance contract has a cash surrender value, only the annual premium in excess of the annual increase in cash surrender value is considered a negative basis adjustment. If the increase in cash surrender value exceeds the premium, an upward basis adjustment equal to such excess is appropriate.

Rev. Rul. 96-10 clarifies that if a loss on the sale of partnership property is disallowed under IRC Sec. 707(b)(1), the basis of each partner's interest in the partnership (outside basis) is still decreased (but not below zero) under IRC Sec. 705(a)(2) by that partner's share of the loss. Rev. Rul. 96-10 also indicates that if gain from the sale of partnership property is not recognized due to the application of IRC Secs. 707(b)(1) and 267(d), each partner's outside basis is increased under IRC Sec. 705(a)(1) by the partner's share of that gain. Rev. Rul. 96-11 indicates that if a partnership makes a charitable donation of property, each partner's outside basis is decreased (but not below zero) by the partner's share of the partnership's basis in the donated property.

Example 1D-1 Adjustments for partnership operations.

In January, Bruce and Lance form Freedom Makers, a 50/50 partnership, providing personal assistance to busy executives. Bruce contributes $10,000 and Lance contributes depreciable property with a $10,000 FMV and a $5,000 adjusted basis. During the year, the partnership realizes $54,000 of net income (before depreciation). The partnership also recognizes $1,500 of depreciation expense with respect to the property Lance contributed. All partnership tax items are allocated equally to the partners except for certain tax depreciation, which is allocated solely to Bruce to satisfy the requirements of IRC Sec. 704(c). Bruce and Lance compute their outside bases as follows:

	Bruce	Lance
Initial basis	$ 10,000	$ 5,000
Depreciation—IRC Sec. 704(c)	(1,500)	—
Income	27,000	27,000
Year-end basis	$ 35,500	$ 32,000

Example 1D-2 Adjustments for partnership distributions and nondeductible expenses.

Assume the same facts as in Example 1D-1, except during the year each partner makes a $2,500 cash withdrawal each month ($30,000 for the year). In addition, the partnership pays $1,000 of nondeductible life insurance premiums on policies for which the cash surrender value increases $100 during the year. The adjusted bases for Bruce and Lance at year-end are:

	Bruce	Lance
Initial basis	$ 10,000	$ 5,000
Depreciation—IRC Sec. 704(c)	(1,500)	—
Income	27,000	27,000
Net insurance cost	(450)	(450)
Cash distributions	(30,000)	(30,000)
Year-end basis	$ 5,050	$ 1,550

Example 1D-3 Keeping track of a partner's outside basis to reflect partnership operations.

Daylight Detectives was formed in January 2009 as a 50/50 calendar year general partnership. To get the business started, David Day contributed $10,000 cash, and Maddie Light contributed property, with a $10,000 FMV and a $6,000 basis. The contributed property included a computer and peripherals with a $4,000 FMV and a $1,800 depreciated basis. On 10/15/09, Daylight Detectives sold the computer and peripherals for $3,800, realizing depreciation recapture income of $2,000.

During 2009, Daylight Detectives had net ordinary income of $54,000. It also suffered a capital loss of $800 on a short−term investment and paid $600 in premiums for key−executive term life insurance. All profits and losses were allocated equally between David and Maddie. In addition, each partner received cash distributions of $24,000 during 2009.

With one exception, the basis adjustments to David's and Maddie's interests are identical. The exception is that the $2,000 gain realized on the sale of the computer must be allocated solely to Maddie [under IRC Sec. 704(c)], because this gain reflects the difference in the property's adjusted basis and FMV at the time of contribution. The adjustments to David's and Maddie's outside basis for 2009 are as follows:

	David	Maddie
Beginning basis	$ 10,000	$ 6,000
Section 704(c) gain	—	2,000 [a]
2009 income	27,000	27,000
2009 distributions	(24,000)	(24,000)
2009 capital loss	(400)	(400)
2009 life insurance premiums (nondeductible for tax purposes)	(300)	(300)
Ending 2009 basis	$ 12,300	$ 10,300

2010 did not turn out to be a very good year. David had to contribute an additional $10,000 to the business. Operating losses for the year totaled $22,000. The partners' bases at the end of the year are—

	David	Maddie
Beginning basis	$ 12,300	$ 10,300
Capital contributions	10,000	—
2010 operating losses	(11,000)	(11,000)[b]
Ending 2010 basis	$ 11,300	$ -0-

Notes:

[a] This will be ordinary income under IRC Sec. 1245.

[b] Maddie can only deduct $10,300 of the loss on her tax return because of the Section 704(d) basis limitation.

Maddie's ending basis in her partnership interest is zero. She has a suspended loss of $700 that she can deduct in the future when she has sufficient basis in her partnership interest. The practitioner needs to maintain a schedule showing the suspended loss available for deductions in future years when there is basis.

Contributing Corporate Partner's Own Stock

Rev. Rul. 99-57 indicates that if a corporate partner contributes its own stock to a partnership in exchange for a partnership interest, and the partnership later exchanges the stock in a taxable transaction, then the partnership will realize gain that will be allocated to the partners under IRC Sec. 704. Under IRC Sec. 1032, however, the corporate partner will not recognize the gain allocated to it with respect to the sale or exchange of the stock. Furthermore, under IRC Sec. 705, the corporate partner increases its outside basis by an amount equal to its share of the gain resulting from the partnership's sale or exchange of the stock.

In connection with Rev. Rul. 99-57, the IRS issued Reg. 1.705-2 which bars corporate partners from adjusting their outside basis when that partnership owns, then sells, the corporation's stock. These regulations apply to a corporation that acquires a partnership interest when there is no Section 754 election in effect for that partnership. The intent is to limit a corporation's outside basis increase to the amount of its share of Section 1032 gain that it would have realized if a Section 754 election had been made.

For example, assume XYZ Corporation purchased a 50% interest in ABC Partnership (ABC) for $100,000. ABC's only asset is XYZ stock, with a $100,000 basis and a $200,000 FMV. If ABC does not make a Section 754 election when it disposes of its XYZ stock for $200,000, XYZ would be allocated a $50,000 gain. Under IRC Sec. 1032, the gain allocated to XYZ is not taxable. If XYZ's outside basis in ABC was increased to $150,000 under IRC Sec. 705(a)(1), XYZ would recognize a corresponding $50,000 loss (or reduced gain) when selling its interest in ABC Partnership. In this case, it is inconsistent with the intent of IRC Sec. 705 to increase XYZ's outside basis in ABC Partnership for the gain XYZ did not have to recognize. To do so would allow a tax loss (or reduced gain) where no economic loss was incurred and no offsetting taxable gain was previously recognized.

The Zero Basis Rule

A partner can deduct partnership losses only to the extent of his or her adjusted basis in his or her partnership interest (outside basis) at the partnership's tax year-end. A loss exceeding a partner's basis carries forward (maintaining its character as ordinary, capital, passive AMT preference, etc.) and is deductible only when the partner's basis increases in succeeding years.

A partner's outside basis can never be less than zero. This limitation, the so-called zero basis rule, comes into play in determining whether cash distributions are taxable. It also limits the basis assigned to property received in distributions. Cash distributions (including deemed cash distributions from a reduction in the partner's share of liabilities) in excess of outside basis result in taxable gain to the partner to the extent of such excess.

Example 1D-4 The zero basis rule.

Ted is a partner in Mississippi Dusters, a general partnership. Ted's outside basis in the partnership is $5,000, and his specially allocated share of the current year's taxable loss is $7,900.

Since Ted cannot have a basis less than zero, he will not be able to deduct the full $7,900 loss. He can deduct $5,000 currently, and an increase in the remaining $2,900 will be deferred until his basis is increased (for example, by a contribution or his share of undistributed partnership income).

Effect of Deferred Losses on Outside Basis

There are multiple restrictions on a partner's ability to deduct partnership losses (i.e., the passive loss rules, the at-risk rules, etc.). However, even if the deductibility of a partnership loss is suspended or limited by one of these restrictions, the full amount of the loss before any applicable limitations reduces the partner's outside basis, subject only to the zero basis rule. For example, Rev. Rul. 89-7 states the full amount of the partner's Section 179 deductions passed through by the partnership reduces the partner's outside basis even if the partner cannot claim the full Section 179 deduction due to partner-level limitations.

Example 1D-5 Deferred loss.

Carol is a partner in Delta Queens, a general partnership that manufactures playing cards. Carol's outside basis is $25,000, and her share of the current year's loss is $10,000. Carol does not materially participate in the business, but has $4,000 of other passive income.

Under the passive loss rules of IRC Sec. 469, Carol can only deduct $4,000 of Delta Queens' current year loss. The remaining $6,000 of loss is suspended and used in future years against any passive income. However, Carol's outside basis is reduced by the full $10,000, even though $6,000 cannot be deducted currently.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. A partnership pays $1,500 a year for nondeductible life insurance premiums. The policies' cash surrender value increases $150 during the year. How does this affect the basis of the partners?

    a. It does not affect basis, because it is nondeductible.

    b. Partners share the premiums as flow-through income that is not reflected in basis.

    c. Partners share the net insurance cost as a reduction of basis.

12. An equal general partnership is formed with partner A contributing $5,000 cash and partner B contributing property with adjusted basis of $3,000 and FMV of $5,000. Near the end of the first year some of the contributed property was sold. The sold property had a depreciated basis of $900 and a FMV of $2,000, and was sold for $1,900. Depreciation recapture income of $1,000 was realized on the sale. During the first year's operation, the partnership had net ordinary income of $27,000, realized capital loss of $400 in short-term investments, and paid $300 in key man life premiums. Each partner received $12,000 in cash distributions during the year. Basis adjustments for each partner are identical, except that the gain on sale of contributed property is allocated solely to partner B. What is partner B's adjusted basis at the end of year one?

    a. $17,500.

    b. $12,350.

    c. $6,150.

    d. $5,150.

13. An equal general partnership is formed with partner A contributing $50,000 cash and partner B contributing property with adjusted basis of $30,000 and FMV $50,000. Near the end of the first year, some of the contributed property was sold. The sold property had a depreciated basis of $9,000 and FMV $20,000, and was sold for $19,000. Depreciation recapture income of $10,000 was realized on the sale. During the first year's operation, the partnership had net ordinary income of $270,000, realized capital loss of $4,000 in short-term investments, and paid $3,000 in key man life premiums. Each partner received $120,000 in cash distributions during the year. Basis adjustments for each partner are identical, except that the gain on sale of contributed property is allocated solely to partner B. What is partner A's adjusted basis at the end of year one?

    a. $50,000.

    b. $51,500.

    c. $61,500.

    d. $123,500.

14. Partnership losses are deductible by the partner—

    a. even though the partner's outside basis is negative.

    b. only to the extent of adjusted basis in the partnership interest.

    c. under no circumstances.

15. A partner's outside basis is $20,000, share of current loss is $8,000, and has other passive income of $3,200. The partner does not materially participate in the business. How much of the current loss can be deducted by the partner?

    a. $3,200.

    b. $4,800.

    c. $8,000.

    d. None of the current loss can be deducted.

16. Karen is a partner is Devil's Food, Inc, a general partnership. Karen's outside basis in the partnership is $100,000 and her allocated losses for the year from the partnership are $120,000. What is Karen's new basis in the partnership after the loss is distributed?

    a. ($20,000).

    b. $0.

    c. $20,000.

    d. $100,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. A partnership pays $1,500 a year for nondeductible life insurance premiums. The policies' cash surrender value increases $150 during the year. How does this affect the basis of the partners? **(Page 19)**

    a. It does not affect basis, because it is nondeductible. [This answer is incorrect. Increases in cash surrender value have an impact on basis per IRC Sec. 705.]

    b. Partners share the premiums as flow-through income that is not reflected in basis. [This answer is incorrect. Distributions such as payment of premiums are reflected in partner's basis per IRC Sec. 705.]

    c. Partners share the net insurance cost as a reduction of basis. [This answer is correct. Insurance cost is netted and applied to reduce basis of the partners, since only the excess of the annual premiums over the annual increase in cash surrender value is considered a negative adjustment.]

12. An equal general partnership is formed with partner A contributing $5,000 cash and partner B contributing property with adjusted basis of $3,000 and FMV of $5,000. Near the end of the first year some of the contributed property was sold. The sold property had a depreciated basis of $900 and a FMV of $2,000, and was sold for $1,900. Depreciation recapture income of $1,000 was realized on the sale. During the first year's operation, the partnership had net ordinary income of $27,000, realized capital loss of $400 in short-term investments, and paid $300 in key man life premiums. Each partner received $12,000 in cash distributions during the year. Basis adjustments for each partner are identical, except that the gain on sale of contributed property is allocated solely to partner B. What is partner B's adjusted basis at the end of year one? **(Page 19)**

    a. $17,500. [This answer is incorrect. $17,500 considers only the initial contribution, the gain, and the share of net income. Deductions from basis need to be in the calculation.]

    b. $12,350. [This answer is incorrect. $12,350 equals the total deductions from basis.]

    c. $6,150. [This answer is incorrect. $6,150 is the basis for partner A at the end of year one.]

    d. $5,150. [This answer is correct. Partner B contributed property for $3,000, had a $1,000 gain, net income share of $13,500, distributions of $12,000, capital loss share of $200, and life insurance premium share of $150 ($3,000 + 1,000 + 13,500 − 12,000 − 200 − 150 = $5,150).]

13. An equal general partnership is formed with partner A contributing $50,000 cash and partner B contributing property with adjusted basis of $30,000 and FMV $50,000. Near the end of the first year, some of the contributed property was sold. The sold property had a depreciated basis of $9,000 and FMV $20,000, and was sold for $19,000. Depreciation recapture income of $10,000 was realized on the sale. During the first year's operation, the partnership had net ordinary income of $270,000, realized capital loss of $4,000 in short-term investments, and paid $3,000 in key man life premiums. Each partner received $120,000 in cash distributions during the year. Basis adjustments for each partner are identical, except that the gain on sale of contributed property is allocated solely to partner B. What is partner A's adjusted basis at the end of year one? **(Page 19)**

    a. $50,000. [This answer is incorrect. This considers only the initial contribution, the gain and the share of net income, distributions, and other deductions from basis need to be included in the calculation.]

    b. $51,500. [This answer is incorrect. It is the basis for partner B.]

    c. $61,500. [This answer is correct. Partner A contributed cash of $50,000, had a net income share of $135,000, distributions of $120,000, capital loss share of $2,000, and life insurance premium share of $1,500.]

    d. $123,500. [This answer is incorrect. $123,500 equals the total deductions from basis.]

14. Partnership losses are deductible by the partner— **(Page 19)**

   a. even though the partner's outside basis is negative. [This answer is incorrect. The partner can not deduct the loss currently because a partner's outside basis cannot be less than zero.]

   b. only to the extent of adjusted basis in the partnership interest. [This answer is correct. A partner can deduct partnership losses only to the extent of his or her adjusted basis in the partnership (outside basis) at the partnership's tax year-end, per IRS code.]

   c. under no circumstances. [This answer is incorrect. Deductible losses are allowed under circumstances in which basis does not fall below zero.]

15. A partner's outside basis is $20,000, share of current loss is $8,000, and has other passive income of $3,200. The partner does not materially participate in the business. How much of the current loss can be deducted by the partner? **(Page 19)**

   a. $3,200. [This answer is correct. Passive loss rules of IRC Sec. 469 allows deduction of passive losses only to the extent of passive gains.]

   b. $4,800. [This answer is incorrect. The amount of the passive loss deduction is not calculated by taking the difference between the amount of the loss and the amount of passive income.]

   c. $8,000. [This answer is incorrect. Passive loss rules of IRC Sec. 469 do not allow full deduction of the loss.]

   d. None of the current loss can be deducted. [This answer is incorrect. The loss is deductible, but the deductible amount is limited per IRC Sec. 469.]

16. Karen is a partner is Devil's Food, Inc, a general partnership. Karen's outside basis in the partnership is $100,000 and her allocated losses for the year from the partnership are $120,000. What is Karen's new basis in the partnership after the loss is distributed? **(Page 19)**

   a. ($20,000). [This answer is incorrect. A partner's outside basis can never be less than zero, per IRS code.]

   b. $0. [This answer is correct. Karen can deduct the loss from her basis until she has depleted the entire basis, but a partner's outside basis can never be less than zero. She can defer the remaining loss until her basis has increased.]

   c. $20,000. [This answer is incorrect. Karen's allocated loss for the year is greater than her beginning outside basis, so there would not be a gain of taking the total loss from the current basis amount.]

   d. $100,000. [This answer is incorrect. Karen can reduce her outside basis amount by the loss allocated by the current year's taxable loss.]

How to Determine a Partner's Outside Basis

Under IRC Sec. 704(d), a partner's allocable share of loss is deductible only to the extent of the partner's outside basis at the partnership's year-end. In determining a partner's outside basis at year-end, adjustments for increases and decreases are made in a specific order according to Reg. 1.704-1(d)(2).

First, the partner's basis is increased by all positive basis adjustments (including current-year cash and property contributions) and all items of income (both taxable and nontaxable).

Next, basis is decreased (though not below zero) for current-year distributions. While nonliquidating distributions may have been made throughout the year, they are generally deemed to have been made on the last day of the partnership year. If both cash and other property are distributed in the same transaction or are deemed to have been distributed at year-end, the cash is considered to be distributed first.

Finally, basis is decreased (though not below zero) by the partner's share of all items of partnership losses for the year, including any carryovers from prior years.

Example 1E-1 Limiting a deductible loss after adjusting basis.

Stephanie is a partner in Carolina Travelers, a general partnership operating a travel website. Her outside basis at the beginning of the year is $5,000. The partnership loss allocated to her this year is $3,500, consisting of $3,000 of ordinary loss and $500 of capital loss. The partnership also distributes $3,000 (treated as an advance or draw) to her during the year.

The $3,000 distribution is a tax-free return of partner capital reducing Stephanie's $5,000 partnership basis to $2,000—prior to the adjustment for any current-year losses. Since Stephanie cannot reduce her basis below zero, she will be allowed to deduct only $2,000 of her allocable loss. The remaining $1,500 loss will carry forward until there is adequate basis to claim the deduction. (If the partnership waits until next year to distribute cash to Stephanie, she may have sufficient basis to claim the full $3,500 loss.) However, unless there is income next year, only $1,500 of the $3,000 distribution will be tax-free. The remaining $1,500 will be taxable since it exceeds her basis. Example 1E-2 discusses the composition of the suspended losses.

Allocation of Suspended Loss Among Separate Components and Impact on AMT Items

As noted previously, when the loss allocated to a partner exceeds his or her outside basis, the deductible loss is limited by IRC Sec. 704(d). Typically, the partner's overall net loss is made up of several separately stated components that may include long-term or short-term capital loss, ordinary loss from operations, investment interest expense, etc. In a year in which the various separately stated partnership items combine to produce an overall loss that exceeds the partner's outside basis, it becomes necessary to determine which loss items are reported currently and which items are deferred. Another equally important determination is whether deductions that are AMT preference or adjustment items are deducted currently or deferred.

Generally, if a partner is limited by outside basis and cannot deduct his or her full loss, he or she is allowed to deduct a prorata portion of each separately stated partnership item making up the net loss—including amounts carried over from prior years because of prior-year basis limitations. The balance can be deducted later when and if the partner's basis increases. The passive activity rules also follow this prorata treatment when determining the character of items deducted in the current year or carried forward.

Example 1E-2 Composition of suspended loss when basis limitation applies.

Rhonda, a partner in Southwest Teachers Supply (STS), has been allocated a Year 1 net loss of $10,000, but her outside basis is only $7,000. The $10,000 loss includes $1,000 of Section 179 expense and a $3,000 passive activity loss. The remaining loss of $6,000 includes a $2,000 AMT preference related to the depreciation deduction. Rhonda determines her Year 1 reportable and deferred items as follows:

	Allocated Loss Items	Allowable Factor ($7,000 ÷ $10,000)	Reported in Year 1	Deferred Loss
Section 179 deduction	$ 1,000	70%	$ 700	$ 300
Passive activity loss	3,000	70%	2,100	900
Remaining loss	6,000	70%	4,200	1,800
Total loss	$ 10,000		$ 7,000	$ 3,000
AMT preference	$ 2,000	70%	$ 1,400	$ 600

The amounts reported in Year 1 are deducted from Rhonda's outside basis. The $7,000 of allowable deductions reduce Rhonda's outside basis to zero at the end of Year 1. Even if she determines she cannot claim the full $7,000 STS loss in Year 1 (for example, because of the passive activity rules), she nevertheless reduces her outside basis by the full amounts in the "Reported in Year 1" column.

If Rhonda has a basis limitation again in Year 2, the $3,000 of Year 1 deferred losses are included with the Year 2 losses. In other words, the "Deferred Loss" items from Year 1 (including the deferred AMT preference) would be included along with Year 2 amounts in the "Allocated Loss Items" column for Year 2. Thus, the denominator in the Year 2 "Allowable Factor" also will include the $3,000 in deferred losses from Year 1.

Outside Basis Adjustment from Noncash Distribution

A partner receiving a property distribution (as opposed to a distribution of cash and certain marketable securities treated as cash) reduces his or her outside basis by the basis he or she takes in the distributed property.

The basis of property distributed in a nonliquidating distribution is the lesser of (1) the partnership's basis in the property immediately prior to the distribution, or (2) the partner's basis in the partnership interest, reduced—but not below zero—by any money distributed in the same transaction. (A special rule applies to distributed unrealized receivables and inventory.) Thus, a partner's basis in the distributed property is limited to his or her outside partnership basis before the distribution.

Example 1E-3 Basis adjustments upon distribution of cash and property.

Ed and John are equal partners in Two Dudes Partnership, a small investment partnership. At the beginning of the year, Ed has a $5,000 basis in his partnership interest, while John (who purchased his interest from William just before the beginning of the current tax year) has a $9,000 basis. The partnership did not make a Section 754 election and has no net income or loss for the year. At year-end, the partnership distributes $2,500 cash and stock with a $7,000 FMV to each partner. The partnership has a $4,000 tax basis in the stock distributed to each partner. Assume the rules of IRC Sec. 731(c)(1) that treat the distribution of certain marketable securities as distributions of cash do not apply. Ed and John adjust their outside partnership bases as follows:

	Ed	John
Outside basis at beginning of year	$ 5,000	$ 9,000
Cash distribution	(2,500)	(2,500)
Basis before stock distribution	2,500	6,500
Stock distribution	(2,500)	(4,000)
Ending outside basis	$ -0-	$ 2,500

Ed and John each adjust their basis for the cash distribution before making the adjustment for the property distribution. Ed's stock basis is limited to his outside basis after the cash distribution ($2,500). John's stock basis equals the partnership's $4,000 predistribution basis. The partners have different bases in the stock distributed to them, even though the blocks of stock had the same basis for the partnership. The difference results from the application of the zero basis rule to Ed.

If a Section 754 election is made after the stock distribution, the partnership can increase the basis of its remaining assets by $1,500 (the basis step-down that occurred as the property passed from the partnership to Ed). This basis adjustment is provided for in IRC Sec. 734(b)(1). If a Section 754 election has not been made previously, the election should be made with the return for the year in which the distribution occurs.

If both cash and property are to be distributed within a short period, it usually makes sense to distribute the cash first. Distributed cash reduces outside basis dollar for dollar, and other property can then be distributed without immediate gain recognition. As stated earlier, the basis of the noncash property to the distributee partner is the lower of (1) the partnership's tax basis in the property or (2) the partner's remaining outside basis. If the noncash property is distributed first, the partner's outside basis is reduced dollar for dollar by the partnership's basis in the distributed property. This can result in a remaining outside basis that is less than the cash subsequently distributed. Cash distributions in excess of outside basis result in immediate gain recognition.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. A partner has outside basis of $700, and is allocated a Year 1 net loss of $1,000. The loss includes $100 Sec. 179 expense and a $300 passive activity loss. The rest of the loss is from other operations, including $200 AMT preference for depreciation deduction. If the partner chooses to use the pro-rata approach, how much of the passive activity loss is deferred?

    a. $400.

    b. $300.

    c. $210.

    d. $90.

18. A partner has outside basis of $7,000, and is allocated a Year 1 net loss of $10,000. The loss includes $1,000 Sec 179 expense and a $3,000 passive activity loss. The rest of the loss is from other operations, including $2,000 AMT preference for depreciation deduction. If the partner chooses to use the pro-rata approach, how much of the passive activity loss should be reported in Year 1?

    a. $700.

    b. $2,100.

    c. $4,200.

    d. $10,000.

19. Partner A has at the beginning of the year outside basis of $10,000. Partner B has $18,000. A Section 754 election is not in place and there is no net income or loss for the year. Year-end distribution was made of $5,000 cash and stock with FMV of $14,000 to each partner. Partnership tax basis in the stock received by each partner is $8,000. Assume the distribution of marketable securities does not have to be treated as a distribution of cash. What is Partner A's ending outside basis?

    a. $3,000.

    b. $0.

    c. ($3,000).

    d. ($9,000).

20. Partner A has at the beginning of the year outside basis of $1,000. Partner B has $1,800. A Section 754 election is not in place and there is no net income or loss for the year. Year end distribution was made of $500 cash and stock with FMV of $1,400 to each partner. Partnership tax basis in the stock received by each partner is $800. Assume the distribution of marketable securities does not have to be treated as a distribution of cash. What is Partner B's ending outside basis?

    a. $1,300.

    b. $1,000.

    c. $500.

    d. $0.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. A partner has outside basis of $700, and is allocated a Year 1 net loss of $1,000. The loss includes $100 Sec. 179 expense and a $300 passive activity loss. The rest of the loss is from other operations, including $200 AMT preference for depreciation deduction. If the partner chooses to use the pro-rata approach, how much of the passive activity loss is deferred? **(Page 27)**

    a. $400. [This answer is incorrect. It is more than the total deferred loss.]

    b. $300. [This answer is incorrect. It is the total amount of the deferred loss.]

    c. $210. [This answer is incorrect. It is the amount reported in the current year.]

    d. $90. [This answer is correct. It is the remaining passive activity loss after prorating all items.]

18. A partner has outside basis of $7,000, and is allocated a Year 1 net loss of $10,000. The loss includes $1,000 Sec 179 expense and a $3,000 passive activity loss. The rest of the loss is from other operations, including $2,000 AMT preference for depreciation deduction. If the partner chooses to use the pro-rata approach, how much of the passive activity loss should be reported in Year 1? **(Page 27)**

    a. $700. [This answer is incorrect. It is the Sec. 179 depreciation reported in Year 1.]

    b. $2,100. [This answer is correct. It is the amount of passive activity loss reported in the current year.]

    c. $4,200. [This answer is incorrect. It is the total amount of the remaining losses reported in Year 1.]

    d. $10,000. [This answer is incorrect. It is the total amount of loss allocated for Year 1.]

19. Partner A has, at the beginning of the year, outside basis of $10,000. Partner B has $18,000. A Section 754 election is not in place and there is no net income or loss for the year. Year end distribution was made of $5,000 cash and stock with FMV of $14,000 to each partner. Partnership tax basis in the stock received by each partner is $8,000. Assume the distribution of marketable securities does not have to be treated as a distribution of cash. What is Partner A's ending outside basis? **(Page 27)**

    a. $3,000. [This answer is incorrect. A does not have sufficient basis to achieve this result.]

    b. $0. [This answer is correct. A's basis is zero because the partner's basis cannot be reduced below zero.]

    c. ($3,000). [This answer is incorrect. This answer choice properly reflects the basis of the marketable securities distributed, however, it ignores the basis limitation.]

    d. ($9,000). [This answer is incorrect. The amount reflects FMV of the stock instead of basis, and reduction of basis below zero.]

20. Partner A has at the beginning of the year outside basis of $1,000. Partner B has $1,800. A Section 754 election is not in place and there is no net income or loss for the year. Year end distribution was made of $500 cash and stock with FMV of $1,400 to each partner. Partnership tax basis in the stock received by each partner is $800. Assume the distribution of marketable securities does not have to be treated as a distribution of cash. What is Partner B's ending outside basis? **(Page 27)**

    a. $1,300. [This answer is incorrect. This result only takes into effect the cash distribution.]

    b. $1,000. [This answer is incorrect. This answer choice reflects the basis of the marketable securities distributed, however, it does not allocate the cash distributed.]

    c. $500. [This answer is correct. The amount reflects the basis reduction due to the FMV of the distributed stock, and reduction of basis due to the cash distributed.]

    d. $0. [This answer is incorrect. This is A's basis].

What Constitutes a Partnership Liability?

Under IRC Sec. 752, partnership liabilities can consist of amounts owed by the partnership in connection with the purchase of property, and amounts owed to a partner—so long as (1) the partner is intended to be treated as a nonpartner in connection with the transaction, and (2) the transaction is bona fide. If the partnership owns property subject to a liability, such as real estate acquired subject to a preexisting mortgage debt, the liability is deemed a partnership liability even if the partnership has not legally assumed the obligation to pay it. This debt qualifies as a *liability* to the extent of the property's FMV.

The general purpose of IRC Sec. 752 is to match the partnership's total basis in its assets with the partners' total bases in their partnership interests (i.e., to balance the total *inside* partnership basis with the total of the partners' *outside* bases). According to the regulations, only partnership debt that has an impact on the partnership's inside basis is considered a *liability* that affects the partners' outside bases. Generally, the regulations attempt to coordinate the determination of whether a debt is a *liability* for purposes of applying the basis sharing rules of IRC Sec. 752 with the rules for determining whether or not a liability creates basis or a deduction under the general nonpartnership Code provisions.

For example, a contingent debt is not a *liability* under the Section 752 rules (even though, in many cases, no one would doubt the item was a true debt), because a contingent debt does not create basis. For both cash basis and accrual basis partnerships, the test for whether or not a debt is *contingent* is the *all events* test. This test generally requires (1) all events must have occurred to fix the fact of the liability, and (2) the liability amount must be determinable with reasonable accuracy.

Depending on the partnership's accounting method, even clearly noncontingent partnership debts may not be *liabilities* for Section 752 purposes. For example, a cash basis partnership's accounts payable (for items that, if paid, would be currently deductible) do not qualify as *liabilities*. Since there is no current partnership deduction, there is no *need* for increasing the partners' outside bases to allow the deduction. Thus, the account payable does not count as a liability under IRC Sec. 752. However, for an accrual basis partnership, the same payable would create a partnership deduction. If the debt were not treated as a *liability* that created outside basis, the partners could be prevented from receiving the current benefit of the deductions attributable to the liability.

Another issue in determining basis from debt is whether a debt is a true debt. For purported recourse debts, this involves determining whether the purported debt is in reality an interest in the partnership versus an amount owed to a creditor. This issue arises most frequently in complex partnership structures. For example, many tax-exempt lenders hold notes that have a "participation feature," enabling the lender to get a return based on the success of the partnership. Often, this return is based on the appreciation of the partnership's property (i.e. a shared appreciation mortgage). Thus, the tax-exempt lender arguably benefits just as any other partner would. However, by classifying the transaction as a debt, the partnership and the tax-exempt lender benefit. The tax-exempt lenders have interest income instead of unrelated business income. The partnership can increase the tax basis of its other partners by their shares of the liability, and the arrangement permits the partnership to take cost-recovery deductions without application of certain limitations related to tax-exempt use property.

Unfortunately, there is no hard and fast rule on when a transaction is a debt versus a disguised partnership interest. Each case must be determined on its facts and circumstances. However, the critical factor is whether the purported lender is actually participating in the venture as a risk-taking entrepreneur or simply seeking a fair return that is independent of the success of the partnership.

The following factors are indicative of the types of factors a court would use in deciding whether a transaction results in a loan or an equity investment for tax purposes:

- Whether a fixed repayment date existed in the near future. This is probably the most decisive factor
- The existence of adequate collateral for the loan evidenced by a pledge or mortgage of property with a value greater than the loan
- The extent to which the loan is subordinated to other liabilities

- The extent to which the return on the loan is fixed and not dependent on profit
- Whether or not the partnership is adequately capitalized
- Whether or not there is a true expectation of repayment
- Whether the debt is convertible

The *Old* Rules versus the *New* Rules for Allocating Liabilities to Partners

Although the Code attaches significant tax consequences to partners' allocations of partnership liabilities, IRC Sec. 752 itself provides no rules for determining the amounts of those shares. That task is left to the regulations. For 32 years, Treasury's guidance was limited to regulations originally issued in 1956. In very general terms, these *old* rules provided that partners shared recourse liabilities in accordance with their ratios for sharing partnership losses. However, liabilities for which no partner had personal liability (i.e., nonrecourse liabilities) were allocated among the partners in proportion to their shares of partnership profits.

Effective Dates

In general, the old rules continue to apply to basis allocations from debt incurred before 1/30/89. The intent is to *grandfather* the basis allocation from debt incurred prior to the issuance of the new regulations. Such debt, unless it is materially modified, will not be affected by the new rules. The old rules also apply to liabilities incurred after 1/29/89 if pursuant to a written contract pending prior to 12/29/88. However, with respect to *nonrecourse* amounts directly loaned or directly guaranteed by partners, the new rules are effective retroactive to 3/1/84. This retroactive effective date also applies to *transactions tantamount to a guarantee* by partners. If these *tantamount to a guarantee* rules cause the unexpected retroactive application of the new rules, potentially adverse effects can result for the nonguarantor partners.

Unfortunately, the effective date provisions of the new regulations are complicated. A few partnerships have liabilities subject to three sets of regulations: (1) the former regulations, (2) the temporary regulations, and (3) the final regulations. Proper treatment depends on the nature of the partnership liability. In general, the old regulations apply to pre-1/30/89 liabilities and the temporary regulations apply to liabilities incurred, assumed, or materially modified by partnerships after 1/29/89 but before 12/28/91. Generally, the final regulations apply to liabilities incurred, assumed, or materially modified after 12/27/91. The rules under the temporary and final regulations are discussed later in this lesson.

Direct Partner Nonrecourse Loans and Guarantees

A retroactive effective date applies to direct partner *nonrecourse* loans and direct partner guarantees of partnership nonrecourse loans (i.e., when a partner is the creditor or guarantor). In such cases, the temporary regulations apply to liabilities incurred, assumed, or materially modified on or after 3/1/84. Under these rules, basis from direct partner nonrecourse loans (or from partner guarantees of nonrecourse loans) is allocated 100% to the lender or guarantor partner.

Because many partnerships have received nonrecourse loans directly from partners or have had nonrecourse partnership loans guaranteed directly by partners, the retroactive effective date of the new rules caused an immediate and retroactive shift in the basis from such loans to the lender or guarantor partners (and away from any other partners who had previously included any share of such liabilities in the bases of their partnership interests).

Recourse versus Nonrecourse Liabilities under the *New* Rules

To apply the Section 752 rules to allocate basis from partnership debt to partners, the practitioner must first distinguish between recourse and nonrecourse liabilities as they are defined for purposes of the Section 752 rules.

Recourse Liabilities

Under Reg. 1.752-1(a)(1), a partnership liability is treated as a recourse liability to the extent any partner bears the *economic risk of loss* with respect to the liability. This economic risk of loss is present only if any partner (whether in his capacity as a partner or otherwise) or any person related to a partner would be obligated to make a payment to the creditor or a partnership contribution upon a constructive liquidation of the partnership under certain hypothetical circumstances. This hypothetical *no value liquidation* assumes all partnership assets (including cash) are worthless.

Example 1H-1 Allocating recourse debt.

Ray and Jeff, equal general partners, each contribute $1,000 to form Shade Tree Venture. Deb, the sole limited partner, contributes $18,000. The partnership uses $10,000 for miscellaneous expenses and borrows $90,000 to purchase partnership property. Assume the loan is a recourse debt because Ray and Jeff are personally liable for it. The remaining $10,000 is used to pay start-up costs.

Under a constructive *no value liquidation*, Ray and Jeff, as general partners, are obligated to contribute $45,000 each to satisfy the recourse liability and are each allocated $45,000 of the liability for basis purposes. As a limited partner, Deb is not obligated to make any contribution to pay the recourse debt and is, therefore, not allocated any of the debt for basis purposes.

Nonrecourse Liabilities

For purposes of the Section 752 rules, a nonrecourse liability is defined as a partnership liability (or a portion of a liability) for which no partner bears the economic risk of loss. Only the creditor bears the economic risk of loss with respect to a nonrecourse liability. The most common type of nonrecourse liability is a loan for which property (typically real estate) is pledged as security for repayment and for which the lender's only remedy in the event of a default is to foreclose on the property.

Example 1H-2 Allocating nonrecourse debt.

Assume the same facts presented in Example 1H-1 except the partnership borrows the $90,000 on a nonrecourse basis. Further assume that Ray and Jeff are each allocated 5% of the partnership's income and losses and Deb is allocated 90%.

In this case, the nonrecourse debt is allocated in accordance with the partners' profit sharing ratios. Therefore, $81,000 is allocated to Deb and $4,500 is allocated to both Ray and Jeff.

Qualified Nonrecourse Financing

While the Section 752 rules provide that a partner's share of partnership nonrecourse debt adds to that partner's basis in the partnership interest, a partner's share of nonrecourse debt generally does *not* generate basis for purposes of the Section 465 at-risk rules. Under an exception, a partner's share of partnership debt that meets the definition of qualified nonrecourse financing does generate at-risk basis for that partner. Qualified nonrecourse financing is debt that: (1) is borrowed in connection with the activity of holding real property and (2) meets several other requirements.

For purposes of allocating basis to partners from partnership debt under the Section 752 rules, there is no distinction between garden-variety nonrecourse debt and nonrecourse debt that meets the definition of qualified nonrecourse financing. The distinction is only relevant for purposes of applying the Section 465 at-risk rules.

For instance, a decrease in a partner's share of partnership garden-variety nonrecourse debt is treated as a constructive cash distribution for purposes of determining that partner's basis in the partnership interest. The same is true for a decrease in a partner's share of partnership qualified nonrecourse financing.

Exculpatory Liabilities

An exculpatory liability is a liability that is nonrecourse in that no partner or person related to a partner has any economic risk of loss for the liability, but that is not secured by specific partnership property. In effect, an exculpatory liability is a recourse liability to the partnership as an entity, but a nonrecourse liability with respect to all the partners. The concept of exculpatory liabilities was introduced in the Preamble to 1992 regulations dealing with how to allocate partnership nonrecourse deductions. Exculpatory liabilities are an issue for LLCs and LLPs, but not for garden-variety partnerships. This is because LLCs and LLPs can have liabilities that are recourse to the entity but for which no member or partner is personally liable (i.e., exculpatory liabilities). In contrast, garden-variety partnerships do not have exculpatory liabilities because there is always have at least one general partner that is personally liable for all liabilities that are recourse to the entity.

Bifurcated Debt

As discussed earlier, a liability is recourse or nonrecourse to the extent partners (or partner affiliates) do or do not bear an economic risk of loss. Consequently, if one or more partners bear the economic risk of loss with respect to a portion of a liability, but there is a portion for which no partner bears any economic risk of loss, the liability is bifurcated. The portion for which one or more partners bear an economic risk of loss is treated as a recourse liability for basis purposes and allocated exclusively to the partner or parties who bear that risk of loss. The remainder is treated as a nonrecourse liability.

Nonrecourse Loans from Partners

If a partner or related person (i.e., a partner affiliate—see discussion later in this lesson) makes a loan that would be characterized as nonrecourse if made by an unrelated person because no partner is personably liable, it will be categorized as recourse for basis purposes and be allocated to the partner who made the loan or the partner affiliated with the lender. We will call this type of liability a *partner nonrecourse loan*. The lender partner or partner affiliated with the lender is deemed to bear all economic risk of loss with respect to the loan. As a result, the lender partner or partner affiliated with the lender is allocated 100% of the liability for basis purposes. A similar rule applies to guarantees of nonrecourse debt by a partner or partner affiliate. Note that different effective dates apply to the rules for direct partner loans (and guarantees) and partner affiliate loans (and guarantees).

Example 1H-3 Allocating basis from a partner nonrecourse loan.

Assume the same facts as in Example 1H-2 except Deb loans the $90,000 to the partnership on a nonrecourse basis. Deb is deemed to bear all economic risk of loss with respect to the nonrecourse loan she made. As a result, the $90,000 of basis from the loan is allocated entirely to her under the no-value liquidation concept that applies to recourse loans. No part of the basis from the debt can be allocated to Jeff or Ray.

Favorable *De Minimis* Rule for Certain Partner Nonrecourse Loans and Guarantees

Under a *de minimis* rule, a partner is not deemed to bear the economic risk of loss for a nonrecourse partnership loan from that partner (or that partner's affiliate) if the partner's interest in each and every item of income, gain, loss, deduction, or credit is 10% or less over the partnership's life, and if the loan constitutes *qualified nonrecourse financing* under the at-risk rules. The determination of whether a debt is *qualified nonrecourse financing* for this *de minimis* rule is made without regard to the type of activity for which the debt is used (i.e., it need not be in connection with real estate activities). The rule allows the nonlender partners to continue being allocated basis from the nonrecourse loan owed to another partner (or partner affiliate) so long as the lender partner is predominantly a creditor rather than a partner. Debt qualifying under this *de minimis* rule is treated as a *true* nonrecourse liability. A similar rule applies to partner guarantees of debt incurred after 12/27/91.

Favorable Wrapped Indebtedness Rule

Frequently, a partnership nonrecourse liability owed to a partner or partner affiliate is *wrapped around* a second nonrecourse liability owed to an unrelated creditor. The second liability is referred to as *wrapped indebtedness*. In such cases, the partnership wraparound liability is treated as owed to the unrelated creditor to the extent of the amount of the underlying wrapped indebtedness. This results in the wrapped indebtedness being treated as a *true* nonrecourse liability that can be allocated to all partners for basis purposes.

Example 1H-4 Determining the nature of a *nonrecourse* wraparound mortgage.

Herman owns Commodore Arms—an apartment building he purchased for $370,000. The building is subject to a $300,000 nonrecourse mortgage Herman obtained from an unrelated lender when he purchased the property.

In 2010, Herman forms Leveraged Associates (a 50/50 partnership) with his friend, Sherman. Leveraged Associates will own and operate Commodore Arms. The partnership buys the building from Herman for $400,000, with $75,000 of the purchase price paid in cash. The remaining $325,000 is financed by a nonrecourse promissory note secured by the property and owed to Herman. The partnership's $325,000 note payable (the wraparound note) to Herman wraps around Herman's existing $300,000 nonrecourse note (the wrapped note). The wrapped note remains in place and continues to be secured by a first lien on the building. Herman continues to service the $300,000 wrapped note with the payments from the partnership.

A partnership liability that is nonrecourse but owed to a partner is generally considered a recourse liability. The creditor-partner is deemed to bear 100% of the economic risk of loss with respect to the liability. However, if such a liability wraps around an underlying *true* nonrecourse liability owed to an unrelated creditor, the partnership's wraparound note is treated as owed to the third party creditor to the extent of the wrapped indebtedness.

In this example, the partnership's $325,000 obligation wraps around an underlying $300,000 *true* nonrecourse obligation owed to an unrelated third party. As a result, $300,000 of the wraparound debt is allocated as a *true* nonrecourse liability because, in reality, neither Herman nor Sherman bears any risk of loss for that amount. The remaining $25,000 of the nonrecourse wraparound debt is considered recourse debt and allocated entirely to Herman, the partner-creditor, because Sherman has no personal risk of loss with respect to that amount.

Impact of Partner Affiliate Loans and Guarantees

The character of a liability as recourse or nonrecourse (and determining the partners' share of the liability for basis purposes) depends not only on the partner's relative rights and obligations, but also on those of persons related to partners, i.e., partner affiliates. In determining basis, the rights and obligations of these partner affiliates are attributed to the related partners.

This means such debt is treated as if it is owed to the partner affiliated with the lender (or guarantor). Thus, when a partnership liability is nonrecourse but is owed to a lender (or guarantor) affiliated with a partner, the partner affiliated with the lender (or guarantor) is treated as having 100% of the economic risk of loss and is allocated all of the liability for basis purposes. A favorable *de minimis* rule (discussed earlier in this lesson) may apply when partner affiliates make nonrecourse loans to a partnership or guarantee a partnership's nonrecourse loan.

Definition of Partner Affiliate

The concept of partner affiliates (i.e., related parties to partners) is critical because it may cause a nonrecourse loan to be treated as a recourse loan. This treatment results in allocating 100% of the basis from the loan to the partner affiliated with the lender. In general, a person is affiliated with a partner if that person (1) is not another partner in the same partnership and (2) shares with the partner one of the relationships described by the attribution rules of IRC Sec. 267(b) or controlled partnership rules of IRC Sec. 707(b)(1), subject to certain modifications set forth in Regs. 1.752-1(a)(3) and 1.752-4(b).

The constructive stock ownership rules of IRC Sec. 267(c) apply in determining whether or not these relationships are present.

If a person is related to more than one partner, the person is treated as related only to the partner with the greatest percentage of related ownership at the time of the determination. If two or more partners share the highest percentage of related ownership with a person, the rights and obligations of that related person are allocated equally among those partners.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Direct partner nonrecourse loans and direct partner guarantees of partnership nonrecourse loans are subject to new rules regarding allocation of basis from debt. When were those rules effective?

    a. January 30, 1989.

    b. December 28, 1991.

    c. December 27, 1991.

    d. March 1, 1984.

22. What is *nonrecourse debt*?

    a. A liability for which any partner bears economic risk of loss.

    b. A liability for which the creditor does not bear economic risk of loss.

    c. A liability for which the lender has no recourse in the event of default.

    d. A liability for which no partner bears economic risk of loss.

23. Which of the following happens in a *partner nonrecourse loan*?

    a. The partnership bears all economic risk of loss in respect to the loan.

    b. All partners share the liability for the loan in the ratio of their share of income.

    c. The partner affiliated with the lender bears economic risk of loss.

    d. In the event of default, all partners are jointly liable to the lender.

24. Why is it important to define partner affiliates?

    a. Partner affiliates may affect the sale price of the partnership.

    b. Partner affiliates may cause a nonrecourse loan to be treated as a recourse loan.

    c. Partner affiliates may cause more people to share in the income of the partnership.

    d. Partner affiliates may result in limited partners becoming managers.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. Direct partner nonrecourse loans and direct partner guarantees of partnership nonrecourse loans are subject to new rules regarding allocation of basis from debt. When were those rules effective? **(Page 34)**

    a. January 30, 1989. [This answer is incorrect. It is the date prior to which liabilities were subject to the old rules.]

    b. December 28, 1991. [This answer is incorrect. It is the date before which temporary regulations applied to certain partnership liabilities.]

    c. December 27, 1991. [This answer is incorrect. It is the date after which new final regulations apply to liabilities incurred, assumed or materially modified.]

    d. March 1, 1984. [This answer is correct. For these type loans, the temporary regulations apply for liabilities incurred, assumed, or materially modified on or after March 1, 1984.]

22. What is *nonrecourse debt*? **(Page 34)**

    a. A liability for which any partner bears economic risk of loss. [This answer is incorrect. This defines recourse debt.]

    b. A liability for which the creditor does not bear economic risk of loss. [This answer is incorrect. Only the creditor bears risk in nonrecourse debt.]

    c. A liability for which the lender has no remedy in the event of default. [This answer is incorrect. The lender has access to the collateral.]

    d. A liability for which no partner bears economic risk of loss. [This answer is correct. Per the Section 752 rules, a nonrecourse debt is a partnership liability (or a portion of a liability) for which no partner bears the economic risk of loss.]

23. Which of the following happens in a *partner nonrecourse loan*? **(Page 34)**

    a. The partnership bears all economic risk of loss in respect to the loan. [This answer is incorrect. This answer choice does not properly reflect the placement of the risk of loss.]

    b. All partners share the liability for the loan in the ratio of their share of income. [This answer is incorrect. In this instance, liability is not allocated among the partners.]

    c. The partner affiliated with the lender bears economic risk of loss. [This answer is correct. According to IRS regulations, when there is a partner nonrecourse loan, the lender or partner affiliated with the lender is deemed to bear all economic risk of loss with respect to the loan. As a result, the lender partner or partner affiliated with the lender is allocated 100% of the liability for basis purposes.]

    d. In the event of default, all partners are jointly liable to the lender. [This answer is incorrect. All partners are not jointly liable to the lender, according to IRS regulations.]

24. Why is it important to define partner affiliates? **(Page 34)**

    a. Partner affiliates may affect the sale price of the partnership. [This answer is incorrect. Partner affiliates are related to a partner; their existence is of no consequence in the sales price of the partnership. The concern of a buyer would be the liabilities of the partnership, regardless of source.]

    b. Partner affiliates may cause a nonrecourse loan to be treated as a recourse loan. [This answer is correct. Basis in a nonrecourse loan made by a lender or guarantor to a partner is allocated entirely to the partner affiliated with the lender.]

    c. Partner affiliates may cause more people to share in the income of the partnership. [This answer is incorrect. Partner affiliates by definition are not another partner in the same partnership.]

    d. Partner affiliates may result in limited partners becoming managers. [This answer is incorrect. Partner affiliates are not other partners in the same partnership.]

The Allocation of Recourse Liabilities

Under Reg. 1.752-2(a), partners share recourse liabilities in the same proportions in which they bear the economic risk of loss with respect to the liability. In other words, partners are allocated basis from recourse debt to reflect the manner in which they are legally obligated to bear the economic burden of discharging the liability if the partnership is unable to do so. In a general partnership, the partners usually bear the economic risks of loss with respect to partnership recourse debt in proportion to their stated loss sharing interests and share the recourse partnership liabilities in the same proportions. Limited partners generally have only limited liability (or no liability) for partnership debts, and therefore do not normally have any economic risk of loss for partnership recourse liabilities. Consequently, limited partners normally do not share in partnership recourse liabilities for basis purposes. However, if a limited partner bears an economic risk of loss with respect to a recourse liability, he is allocated basis to the extent of such risk (Example 1I-5).

Determining a Partner's Economic Risk of Loss—*No Value Liquidation* Is Assumed

Under Reg. 1.752-2(b)(1), a partner bears the economic risk of loss with respect to a partnership liability to the extent that, after a no value liquidation (as described later), the partner (or partner affiliate) would be obligated to make a payment to another person or the partnership. The partner (or partner affiliate) is deemed to bear the economic risk of loss only to the extent he is not entitled to reimbursement from another partner (or partner affiliate).

The obligation's existence and amount must be determinable with reasonable certainty and must not be subject to contingencies making it unlikely that it would ever be discharged. However, the partner's ability to actually satisfy the obligation (i.e., the partner's net worth) is generally irrelevant unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Thus, for example, in a limited partnership, a shell corporate general partner is assumed to have the ability to pay all of its partnership obligations.

No Value Liquidation Defined

A no value liquidation is a hypothetical liquidation under the following circumstances:

1. All partnership assets (excluding only contributed property used solely to secure the repayment of a loan, but including cash) are assumed to be worthless.

2. All partnership liabilities are assumed to be due and payable in full.

3. The partnership disposes of its assets in a fully taxable transaction for no consideration (other than relief from liabilities for which the creditor's right to repayment is limited solely to one or more partnership assets, i.e., nonrecourse debt).

4. The partnership allocates all items of income, gain, loss, and deduction among its partners in accordance with the partnership agreement and applicable tax rules and then promptly liquidates.

The *value* of a partner's net payment obligation is adjusted if the partner is not required to satisfy that obligation within a *reasonable period of time* after the partnership liability becomes due and payable. A reasonable period of time for this purpose is defined as the later of the year-end in which the partner's interest is liquidated or 90 days after the liquidation. Otherwise the obligation must be *discounted* using the appropriate AFR. A partner's payment obligation also includes the amount of any money or other property owned by the partner and pledged to secure payment of a partnership liability.

Example 1I-1 Allocation of recourse liabilities to general partners.

Assume Ray and Clay are general partners in RC Partners and each contributes $20,000 to the partnership. The partnership then borrows $60,000 on a recourse basis and purchases property for $100,000. Losses are allocated 90% to Ray and 10% to Clay under the partnership agreement. Under applicable state law governing general partnerships, both Ray and Clay are liable for the full amount of the liability. State law also requires a general partner to restore any deficit capital account balance.

Under the no value liquidation rules, the partnership's assets are deemed worthless and disposed of in a fully taxable transaction, and all liabilities are deemed payable in full. Applying these no value liquidation assumptions, the partnership has a $100,000 taxable loss allocated $90,000 to Ray and $10,000 to Clay. Ray's capital account becomes a negative $70,000, while Clay's capital account is a positive $10,000, as shown in the following capital account analysis:

	Ray	Clay	Total
Capital contribution	$ 20,000	$ 20,000	$ 40,000
Loss upon deemed liquidation	(90,000)	(10,000)	(100,000)
Capital accounts	$ (70,000)	$ 10,000	$ (60,000)

Under his deficit capital account restoration obligation, Ray would be required to contribute $70,000 to the partnership. Thus, the entire $60,000 recourse liability is allocated to Ray for basis purposes. The basis from the liability is not allocated 90/10 as might be expected. The other $10,000 of Ray's contribution obligation relates to the $10,000 positive capital account owed by the partnership to Clay.

Example 1I-2 Using the no value liquidation analysis.

Don and George plan to buy and operate an apartment building. In late 2009, they form Metrocrib, a 50/50 general partnership. Their partnership agreement complies with the Section 704(b) capital account maintenance requirements and contains a deficit capital account restoration provision. On 12/31/09, each partner contributes $10,000, and Metrocrib borrows $900,000 and buys a building for that amount. The loan is recourse and provides for payments of interest only for five years. The partnership's initial basis in the building is $900,000. For the 2010 partnership year, Metrocrib has a $40,000 net loss, of which $30,000 is depreciation. The remaining $10,000 is cash-out-of-pocket expenses. The $40,000 loss is allocated $20,000 each to Don and George.

A partner's share of a partnership recourse liability is determined using the no value liquidation analysis. In a no value liquidation for the 2010 tax year, all of Metrocrib's assets are assumed to become worthless as of 12/31/10. Don and George each have post-liquidation negative capital accounts of $450,000 as follows:

	Don	George	Total
Capital contributions	$ 10,000	$ 10,000	$ 20,000
2010 loss	(20,000)	(20,000)	(40,000)
Deemed loss from no value liquidation[a]	(440,000)	(440,000)	(880,000)
Ending capital	$ (450,000)	$ (450,000)	$ (900,000)

Note:

[a] No value liquidation calculation:

Basis of building net of $30,000 depreciation	$ 870,000
Cash loss	10,000
Total deemed loss	$ 880,000

Under the partnership agreement, the partners' negative capital account balances represent their net contribution obligations. The contributions would be used to pay off the $900,000 recourse debt. Thus, using the no value liquidation analysis, each partner is allocated $450,000 of basis from the $900,000 debt. This 50/50 allocation is not surprising. However, contrast this result with Example 1I-3.

Example 1I-3 No value liquidation analysis with special allocations.

Special allocations can alter partners' shares of partnership liabilities. Assume the same facts as in Example 1I-2 except the partnership agreement specially allocates depreciation 90% to Don and 10% to George. All other items of taxable loss are allocated 50/50. Under the partnership agreement, gain on the property sale is specially allocated in the same proportion to *charge back* for prior special allocations of depreciation. All other income, loss, or gain is allocated 50/50.

In this fact situation, Metrocrib's 2010 $40,000 loss is allocated differently than in Example 1I-2. The partners continue to equally share the $10,000 portion of the loss unrelated to depreciation. The $30,000 of depreciation, however, is allocated 90% ($27,000) to Don, and 10% ($3,000) to George. Don's total share of the 2010 loss is $32,000, while George's is $8,000. Their capital accounts are adjusted as follows:

	Don	George
Beginning 2010 capital account	$ 10,000	$ 10,000
2010 loss	(32,000)	(8,000)
Ending 2010 capital account	$ (22,000)	$ 2,000

At the end of 2010, the capital accounts are not equal, affecting the basis allocation from the $900,000 liability. If Metrocrib were liquidated at the end of 2010 in a hypothetical no value liquidation, it would be deemed to have sold the building for no consideration. This would produce a tax loss equal to the building's basis, which is $870,000 (the $900,000 original cost reduced by $30,000 of 2010 depreciation). In addition, in a no value liquidation, even cash is assumed to be lost. Therefore, the $10,000 cash left at the end of 2010 (before the no value liquidation) generates an additional $10,000 loss. Under their agreement, the $880,000 loss in 2010 is allocated equally to Don and George, reducing their capital accounts as follows:

	Don	George
Capital account prior to no value liquidation (per previous calculation)	$ (22,000)	$ 2,000
Loss on hypothetical liquidation	(440,000)	(440,000)
Capital accounts after hypothetical liquidation	$ (462,000)	$ (438,000)

These negative capital accounts reflect the obligation of each partner to make a net contribution to the partnership (because of the partner's deficit capital account restoration obligation). These contributions would be used to pay off the $900,000 liability. Thus, the negative capital accounts after the no value liquidation represent how Don and George share the basis from the $900,000 recourse partnership liability at 12/31/10. As can be seen, the result is different from the 50/50 allocation that might have been expected. Compare this result to the result in Example 1I-2.

Example 1I-4 Shifting of basis from liabilities as a result of cumulative special allocations.

A partner's share of basis from a liability may shift as a result of the profit and loss allocations made over the course of the partnership's life. Assume the same facts as Example 1I-3 except the partnership has now operated for four more years (2011–2014). The partnership broke even from 2011–2014 except for depreciation. During those four years, Don is allocated $108,000 in depreciation losses while George is allocated $12,000. At 12/31/14, partnership recourse liabilities are still $900,000 and the partners' capital accounts are:

	Don	George
Ending 2010 capital account (see Example 1I-3)	$ (22,000)	$ 2,000
2011–2014 results	(108,000)	(12,000)
Ending 2014 capital accounts	$ (130,000)	$ (10,000)

The building's basis at 12/31/14 is $750,000 ($900,000 original cost less $150,000 of depreciation). In a no value liquidation, the building's basis is treated as a taxable loss and divided equally between the two partners. In addition, the partnership is assumed to lose its remaining $10,000 of cash on hand at 12/31/14. That loss is also allocated 50/50. After the no value liquidation, the partners' capital accounts are as follows:

	Don	George
Capital accounts prior to no value liquidation	$ (130,000)	$ (10,000)
Loss on liquidation	(380,000)	(380,000)
Ending 2014 capital accounts after no value liquidation	$ (510,000)	$ (390,000)

Again, these hypothetical negative capital accounts reflect how the partners share the $900,000 liability for basis purposes as of 12/31/14. The partners' allocations of the liability have shifted from what is shown in Example 1I-3 because of the special allocation's cumulative effect.

Timing and Valuation of Net Payment

To obtain basis from a *payment obligation*, the requirement to make a payment to a creditor or other person with respect to a partnership liability must be satisfied *within a reasonable time* after the liability becomes due and payable. This means a payment obligation is fully taken into account only if the obligation must be satisfied by the later of (1) the partnership year-end in which the partner's interest is liquidated, or (2) within 90 days after such liquidation. This timing requirement is identical to the rules regarding the timing of an obligation to restore a negative capital account under the Section 704(b) safe harbor regulations.

If the net payment obligation is binding but will be satisfied only at a future time (e.g., a promissory note due at a specified future date), only the present value of the obligation at the time of the determination is considered—unless the obligation is subject to an interest charge at least equal to the appropriate AFR. (The present value is calculated by discounting the obligation using the appropriate AFR.)

Payment Obligation Limited to Property

If a partner's (or partner affiliate's) obligation is limited to the value of certain property (e.g., property pledged to secure partnership nonrecourse debt or specific property the partner is obligated to contribute), basis from that obligation is limited to the property's FMV at the time (or its most recent valuation if the property's FMV is not readily ascertainable). However, if the pledged property is an interest in the partnership itself, it is presumed to have a zero value for these purposes.

Allocations of Recourse Liabilities to Limited Partners

A limited partner and a general partner determine their economic risk of loss and share of partnership recourse liabilities for basis purposes in the same manner. However, a limited partner's obligation to make partnership contributions to pay partnership liabilities is, by definition, wholly or partially limited. Thus, limited partners usually do not have any economic risk of loss with respect to partnership recourse liabilities. Usually, therefore, limited partners are not allocated any of the partnership's recourse liabilities for basis purposes.

However, to the extent a limited partner has an unfulfilled obligation to make a contribution to the partnership (such as under a subscription note), a partial obligation to restore a negative capital account, or an obligation to make a payment to a creditor, the limited partner has an economic risk of loss to that extent and is allocated a share of the partnership recourse liabilities under the same rules discussed earlier in this lesson.

Example 1I-5 Allocation of recourse liabilities to a limited partner.

Assume the Gimme Losses, Ltd. partnership has one asset, a building purchased for $200,000 cash and an $800,000 recourse note. Larry, a limited partner, contributed the $200,000 and wants to be allocated all of the depreciation deductions. This can be accomplished by simply allocating all the partnership's losses to Larry and by subjecting Larry to an unlimited obligation to restore his negative capital account. However, such an approach gives Larry more exposure to risk of loss than he bargained for. If, instead, the partnership agreement allocates only the depreciation losses to Larry and allocates all other losses to Greg (the general partner), Larry's capital account becomes negative in a very limited, controlled manner. If Larry has an obligation to restore his negative capital account, the allocation is valid under the Section 704(b) rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. How are deductions or losses relative to a recourse liability allocated to partners?

    a. They are almost always allocated to the partner to whom the liability is allocated for basis purposes.

    b. They are almost always allocated to all partners, both general and limited, equally according to loss-sharing ratios.

    c. They are almost always not allocated to partners, since that is an action limited to the income statement and balance sheet liability accounts.

    d. They are almost always allocated to limited partners, in the same ratio as their share of losses in the partnership.

26. When allocating recourse liabilities, to what extent does a partner bear risk of economic loss?

    a. A partner bears risk of loss only to the extent of the partner's basis.

    b. The partner bears no risk.

    c. After a no-value liquidation, only to the extent the partner is not entitled to reimbursement from another partner.

    d. Limited partners carry the primary risk of loss from partnership liabilities.

27. A partnership is formed with each partner contributing $40,000. The partnership borrows $120,000 on a recourse basis and purchases property for $200,000. Losses are allocated 10% to Partner A and 90% to Partner B. State law holds both partners liable for the full amount of the liability, and requires a general partner to restore any deficit capital account balance. Under a no-value liquidation scenario, what is the allocation of the $120,000 recourse liability?

    a. It is allocated on the basis of each partners share of losses: 10% to A and 90% to B.

    b. It is allocated equally between the partners, with each taking 50% of the obligation, or $60,000.

    c. It is allocated entirely to Partner A, because that is the only partner with a positive capital account balance after the assumed liquidation.

    d. It is allocated entirely to Partner B, because of that partner's capital account restoration obligation.

28. Braden and Aubrey are general partners in ABC LP. Each of them contributes $25,000 to the partnership. Crawford is a third, limited partner. Crawford borrows, on a recourse basis $50,000 and purchases property totaling $75,000 and contributes it to the partnership. Profits and losses are allocated 45% each to Braden and Aubrey and 10% to Crawford in accordance with the partnership agreement. All partners are equally liable, in accordance with state law for Crawford's liability against the property he contributed. All partners are also required to restore any deficit capital account balances. Applying the no value liquidation rules, the partnership has a $100,000 taxable loss allocated $45,000 to Braden, $45,000 to Aubrey, and $10,000 to Crawford. After allocating the loss, how much deficit capital restoration will be owed by Aubrey?

    a. $15,000.

    b. $20,000.

    c. $25,000.

    d. $45,000.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. How are deductions or losses relative to a recourse liability allocated to partners? **(Page 42)**

    a. They are almost always allocated to the partner to whom the liability is allocated for basis purposes. [This answer is correct. Recourse debt is treated the same as nonrecourse debt from an affiliated lender, and allocated entirely to the affiliated partner per Reg. 1.752-2(a).]

    b. They are almost always allocated to all partners, both general and limited, equally according to loss-sharing ratios. [This answer is incorrect. Deductions and losses are virtually always allocated to the same partner who is allocated basis in the liability per Reg. 1.752-2(a).]

    c. They are almost always not allocated to partners, since that is an action limited to the income statement and balance sheet liability accounts. [This answer is incorrect. Deductions and losses are allocated to partners.]

    d. They are almost always allocated to limited partners, in the same ratio as their share of losses in the partnership. [This answer is incorrect. Limited partners do not usually share in recourse liabilities for basis purposes, because it is unusual for them to have liability for partnership debts.]

26. When allocating recourse liabilities, to what extent does a partner bear risk of economic loss? **(Page 42)**

    a. A partner bears risk of loss only to the extent of the partner's basis. [This answer is incorrect. The partner's ability to pay is generally irrelevant and according to Reg 1.752-2(b)(1), it is not how the economic loss would be distributed to the partners in association with recourse liabilities.]

    b. The partner bears no risk. [This answer is incorrect. A partner is allocated basis from recourse debt that reflects their legal obligation to discharge the liability if the partnership cannot.]

    c. After a no-value liquidation, only to the extent the partner is not entitled to reimbursement from another partner. [This answer is correct. Per IRS Reg. 1.752-2(b)(1) the partner is deemed to bear risk of economic loss only to the extent they are not entitled to reimbursement from another partner.]

    d. Limited partners carry the primary risk of loss from partnership liabilities. [This answer is incorrect. Limited partners do not normally have risk of economic loss for partnership recourse liabilities, as stated in IRS regulations.]

27. A partnership is formed with each partner contributing $40,000. The partnership borrows $120,000 on a recourse basis and purchases property for $200,000. Losses are allocated 10% to Partner A and 90% to Partner B. State law holds both partners liable for the full amount of the liability, and requires a general partner to restore any deficit capital account balance. Under a no-value liquidation scenario, what is the allocation of the $120,000 recourse liability? **(Page 42)**

    a. It is allocated on the basis of each partner's share of losses: 10% to A and 90% to B. [This answer is incorrect. In normal circumstances, this is the obvious answer. In this scenario, the capital restoration obligation in state law makes the transaction more complicated.]

    b. It is allocated equally between the partners, with each taking 50% of the obligation, or $60,000. [This answer is incorrect. The allocation is not to divide the amount equally between the partners.]

    c. It is allocated entirely to Partner A, because that is the only partner with a positive capital account balance after the assumed liquidation. [This answer is incorrect. The capital restoration obligation imposed by the state results would not result in the allocation to Partner A in its entirety.]

    d. It is allocated entirely to Partner B, because of that partner's capital account restoration obligation. [This answer is correct. The state law requires that Partner B contribute sufficient capital to restore the deficit in the capital account; thus, the entire amount of debt will be allocated to B.]

28. Braden and Aubrey are general partners in ABC LP. Each of them contributes $25,000 to the partnership. Crawford is a third, limited partner. Crawford borrows, on a recourse basis $50,000 and purchases property totaling $75,000 and contributes it to the partnership. Profits and losses are allocated 45% each to Braden and Aubrey and 10% to Crawford in accordance with the partnership agreement. All partners are equally liable, in accordance with state law for Crawford's liability against the property he contributed. All partners are also required to restore any deficit capital account balances. Applying the no value liquidation rules, the partnership has a $100,000 taxable loss allocated $45,000 to Braden, $45,000 to Aubrey, and $10,000 to Crawford. After allocating the loss, how much deficit capital restoration will be owed by Aubrey? **(Page 42)**

    a. $15,000. [This answer is incorrect. This is the capital balance of Crawford after the allocation of losses for the period.]

    b. $20,000. [This answer is correct. After deducting Aubrey's allocation of loss from her initial capital balance, she would be required to contribute this amount under the deficit capital account restoration rules.]

    c. $25,000. [This answer is incorrect. This is the beginning capital balance for all partners.]

    d. $45,000. [This answer is incorrect. This is the amount of loss attributed to both Braden and Aubrey for the loss incurred during the year.]

How to Allocate *True* Nonrecourse Liabilities

In the case of what we will call a *true* nonrecourse liability (including a non recourse liability that meets the definition of qualified non recourse financing), no partner bears any risk of economic loss. Consequently, the partners' shares of basis attributable to this type of liability must be determined in a manner other than by analyzing their relative economic risks of loss—the approach used to allocate recourse liabilities. The special rules for allocating nonrecourse liabilities owed to or guaranteed by partners or partner affiliates (as opposed to what we are calling true nonrecourse liabilities) are discussed later in this lesson.

Nonrecourse liabilities are generally allocated among the partners in proportion to the partners' *profits interests*. The regulations do not attempt to define *profits interest* but instead provide that such interests are to be determined by taking into account all the facts and circumstances relating to the partners' economic arrangement. The partners can specify which profits interests are to be used, provided the specified interests are *reasonably consistent* with allocations of some *significant* item of partnership income or gain having substantial economic effect. This is the same rule that applies for determining loss allocations related to nonrecourse liabilities under the Section 704(b) safe harbor rules and is designed to coordinate nonrecourse loss allocations with the allocation of the related nonrecourse liabilities for basis purposes.

To maintain consistency with the Section 704(b) safe harbor allocation rules, the Section 752 rules provide that a partner's share of partnership nonrecourse liabilities equals the sum of:

1. the partner's share of partnership hypothetical *minimum gain*, plus
2. the partner's share of what the regulations call "Section 704(c) gain," plus
3. the partner's share of *excess* nonrecourse liabilities.

Partners' Shares of Minimum Gain

A partner's share of partnership minimum gain is generally determined in accordance with the Section 704(b) safe harbor regulations that govern the allocation of partnership losses and deductions attributable to nonrecourse liabilities. Under these rules, minimum gain is defined as the sum of the hypothetical gains a partnership would recognize if, in a taxable transaction, it disposed of all partnership assets that secure nonrecourse liabilities in full satisfaction of those liabilities and for no other consideration. The assets' book value, not the adjusted tax basis, is used when calculating minimum gain.

Example 1J-1 Allocation of nonrecourse debt equal to minimum gain.

Terry and Diane form a limited partnership to acquire and operate a commercial office building. Terry, the general partner, contributes $20,000. Diane, the limited partner, contributes $180,000. The partnership obtains an $800,000 nonrecourse loan and purchases the building for $1 million. The loan is secured only by the property, and no principal payments are required for five years. The partners' capital accounts are maintained according to the Section 704(b) safe harbor rules; liquidating distributions will be made in accordance with positive capital account balances; and Terry must restore his deficit capital account balance, if any, upon liquidation. Diane is not obligated beyond her original cash contribution. The partnership agreement contains a qualified income offset provision and a minimum gain chargeback provision.

Terry and Diane share all partnership items on a 10/90 basis until cumulative partnership income and gain exceed cumulative partnership loss and deductions, which we will call the payout point. After payout, all partnership items are shared equally.

In each of the first three years the partnership has $5,000 of net operating income and a $90,000 depreciation deduction. The partnership has no nonrecourse deductions in Year 1 or 2 because the adjusted basis of the building exceeds the balance of the nonrecourse loan securing the property. However, if the partnership disposed of the building at the end of Year 3 in full satisfaction of the outstanding debt, it would realize a $70,000 gain ($800,000 amount realized less $730,000 adjusted tax basis). This $70,000 represents *minimum* *gain*. Therefore, the partnership has $70,000 of nonrecourse depreciation deductions to be allocated to the partners in Year 3. The partners' capital accounts at the end of Year 3 are:

	Terry	Diane	Total
Capital contribution	$ 20,000	$ 180,000	$ 200,000
Year 1 loss	(8,500)	(76,500)	(85,000)
Year 2 loss	(8,500)	(76,500)	(85,000)
Year 3 loss (without nonrecourse deductions)	(1,500)	(13,500)	(15,000)
Year 3 nonrecourse deductions	(7,000)	(63,000)	(70,000)
Ending capital account	$ (5,500)	$ (49,500)	$ (55,000)

At the end of Year 3, the partnership nonrecourse liability is allocated to the partners first pursuant to their shares of the minimum gain, with any excess allocated pursuant to the partners' shares of partnership profits. In this example, the partners share the after payout profits equally. Therefore, their respective shares of the nonrecourse debt are:

	Terry	Diane	Total
Allocated according to share of minimum gain	$ 7,000	$ 63,000	$ 70,000
Excess allocated according to after payout profit sharing ratios	365,000	365,000	730,000
Total share of debt	$ 372,000	$ 428,000	$ 800,000

Partners' Shares of Section 704(c) Minimum Gain

A partner's share of Section 704(c) minimum gain includes hypothetical taxable gains that (1) would result from a taxable disposition of property that secures nonrecourse liabilities in satisfaction of those nonrecourse liabilities (and for no other consideration), and (2) would be allocated to the partner under IRC Sec. 704(b) or 704(c) to reflect the difference between the basis and FMV of partnership property. Such difference may have arisen at the time property was contributed, or upon a subsequent revaluation of partnership property (and partnership capital accounts) at the time of the admission or withdrawal of a partner.

In Ltr. Ruls. 9815001 and 9815022, the IRS ruled that a real estate partnership's refinancing obligations were nonrecourse in nature. Even though no separate items secured the financing (creditors could have made a claim against all the partnership's property if the partnership defaulted) the IRS stated that when determining the Section 704(c) minimum gain under Reg. 1.752-3(a)(2), the partnership could allocate the obligation among its properties subject to the obligation in any amount that did not exceed the lesser of (1) the FMV of the property or (2) the amount of debt previously allocated to the property and repaid with proceeds of the general obligation financing.

Example 1J-2 Allocation of nonrecourse debt equal to Section 704(c) minimum gain.

Alton and Boomer form a 50/50 partnership. In exchange for his partnership interest, Alton contributes depreciable property with a $40,000 tax basis and a $100,000 FMV. The property is burdened with a $60,000 nonrecourse liability. Boomer contributes $40,000 cash.

The partnership agreement provides for 50/50 allocations of all partnership items of income, gain, deduction, and loss. In addition, the partnership maintains capital accounts in accordance with the Section 704(b) safe harbor rules.

The question here is how the $60,000 of basis from the nonrecourse liability will be allocated between Alton and Boomer under the three-tier Section 752 allocation process described earlier in this lesson.

First-tier Allocation. In this example, there is no partnership minimum gain, because the property's *book basis* ($100,000) exceeds the nonrecourse debt ($60,000). Therefore, there is no first-tier Section 752 allocation to be made.

Second-tier Allocation. The second-tier Section 752 allocation equals the partners' shares (if any) of the Section 704(c) gain that would result from a deemed sale of the property for an amount equal to the nonrecourse debt. Therefore, the second-tier allocation depends on which of the three methods the partnership uses to deal with Section 704(c) gains. These three methods are the traditional method, the traditional method with curative allocations, and the remedial method. The next lesson discusses these methods in more detail.

If the traditional method is used, the Section 704(c) gain allocable to Alton is simply the $20,000 difference between the nonrecourse debt ($60,000) and the tax basis of the property ($40,000). There would also be a book loss of $40,000 (book basis of $100,000 versus deemed sale proceeds of only $60,000), which would be split 50/50 between the partners. After the tax gain and book loss, there are still disparities between the partners' tax and book capital accounts, but they have no impact on the allocation of basis from the nonrecourse debt when the traditional method is employed. Accordingly, the second-tier Section 752 allocation would be $20,000 to Alton and zero to Boomer.

If the traditional method with curative allocations is used, the result is the same. The curative method depends on using allocations from other partnership income items to cure disparities between book and tax capital accounts caused by applying the Section 704(c) rules. However, such curative allocations are not allowed to be taken into account in making Section 752 allocations of basis from the nonrecourse debt—only the Section 704(c) gain allocation resulting from the deemed sale itself can be considered.

If the remedial method is used, the result would be the initial $20,000 Section 704(c) gain allocation to Alton (the difference between the debt and the property's tax basis). Then, Boomer would be given a remedial tax loss allocation of $20,000, to reflect his share of the book loss. Alton would then receive a remedial tax gain allocation of an additional $20,000 to offset the remedial tax loss allocated to Boomer. Thus, the total Section 704(c) gain allocation to Alton would be $40,000. Accordingly, the second-tier Section 752 allocation would be $40,000 to Alton and zero to Boomer.

Third-tier Allocation. The third-tier Section 752 allocation is whatever basis from nonrecourse debt remains after making the first and second-tier allocations. The remainder is termed the *excess* nonrecourse liability amount. The excess amount depends on the Section 704(c) gain allocation method used by the partnership. See the following discussion and Example 1J-3 for how the excess nonrecourse liability is allocated.

Partners' Shares of *Excess* Nonrecourse Liabilities

To the extent a partnership's nonrecourse liabilities exceed the amounts (if any) allocated under the general minimum gain and Section 704(c) minimum gain rules discussed earlier, they constitute *excess* nonrecourse liabilities. Excess nonrecourse liabilities are allocated among the partners in proportion to their percentage interests in partnership profits. In addition, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on Section 704(c) property or property for which reverse Section 704(c) allocations are applicable. Such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the tier two gain. To the extent that this additional method is used and the entire amount of the tier three liabilities is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods previously discussed. Thus, excess nonrecourse liabilities are allocated for basis purposes in essentially the same way as all nonrecourse liabilities were allocated under the old regulation.

The partners' relative interests in partnership profits are generally determined based on all relevant facts and circumstances. However, the partners, by agreement, can specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities. The partners' specified interests will be honored so long as they are consistent with allocations of some other significant item of partnership income or gain that has substantial economic effect. Alternatively, for liabilities incurred after 12/27/91, *excess* nonrecourse liabilities can be allocated in the same manner as the deductions attributable to those nonrecourse liabilities can reasonably be expected to be allocated. Such *excess* post-12/27/91 nonrecourse liabilities need not be allocated under the same method from year to year.

Practitioners should document the basis for an allocation of nonrecourse liabilities, since the IRS has indicated it will use the anti-abuse rules to prevent partnerships from distorting economic reality using debt allocations. Further, if the debt allocation results in a "listed transaction," under the tax shelter reporting rules, the partnership may have substantial additional reporting requirements.

Example 1J-3 Third-tier allocation of *excess* nonrecourse liabilities.

Assume the same facts as in Example 1J-2. The excess nonrecourse liabilities to be allocated between Alton and Boomer (the third-tier Section 752 allocation) is either $40,000 or $20,000. The amount depends on the method (traditional, traditional with curative allocations, or remedial) used for dealing with Section 704(c) gains. If the traditional method or traditional method with curative allocations is used, the excess nonrecourse liability amount is $40,000. If the remedial method is used, the excess amount is $20,000.

As explained earlier, the third-tier allocation can be made in proportion to the profits interests of the partners (such interests can be specified by agreement). Or it can be made in proportion to how the partnership reasonably expects to allocate nonrecourse deductions attributable to the property.

The overall profit sharing arrangement between Alton and Boomer (50/50) could be used to make the third-tier allocation. Therefore, if the partnership uses either the traditional method or the traditional method with curative allocations, the third-tier allocation would be $20,000 to Alton and $20,000 to Boomer. If the remedial method is used, the third-tier allocation would be $10,000 to Alton and $10,000 to Boomer.

Alternatively, the partnership could make the third-tier allocation in proportion to the expected allocation of nonrecourse deductions from the property. If this is done, the result would be an allocation of 100% of the excess nonrecourse liability amount to Boomer, because all nonrecourse deductions from the property are required to be allocated to him. Therefore if the partnership uses either the traditional method or traditional method with curative allocations, the third-tier allocation would be $40,000 to Boomer and zero to Alton. If the remedial method is used, the third-tier allocation would be $20,000 to Boomer and zero to Alton.

In TAM 200436011, the IRS held that allocating 100% of the excess nonrecourse liabilities to an LLC member was inappropriate where the allocation was based on the gross income allocated to that member. In this TAM, the taxpayer was an LLC taxed as a partnership and the LLC's operating agreement required a preferred return to a single member. All of the gross income was allocated to the owner of the preferred interest up to the amount of the preference. For the year in question, 100% of the income was allocated to the member. The taxpayer argued that the allocation should be respected because it was consistent with a significant item of income or gain. However, the IRS concluded that the term "significant item of income or gain" refers to a significant class of income or gain. This means that the income or item must be of a particular type or character, such as gain from the sale of property. The third-tier allocation is intended to match the excess nonrecourse deductions with the member's share of a significant economic item of income or gain, something that an allocation of gross income does not accomplish.

The new rules for allocating basis from nonrecourse liabilities draw upon the concepts contained in the Section 704(b) safe harbor rules for the allocation of nonrecourse deductions. In effect, these new Section 752 regulations make the Section 704(b) safe harbor rules mandatory for purposes of allocating basis from nonrecourse debt. The bookkeeping required to comply with the Section 704(b) safe harbor rules is complex, and it is unlikely that most partnerships can or will comply—nor is it required that they do so. Therefore, it is unreasonable to require taxpayers to use those same rules to allocate basis from nonrecourse liabilities.

If a partnership chooses *not* to comply literally with the Section 752 nonrecourse liability rules, the authors suggest the partnership consider allocating nonrecourse liabilities using the following *tax basis* approach:

1. First, determine the Section 704(c) minimum gain with respect to contributed property (if any) using tax-basis numbers (rather than *book* numbers). Allocate basis from nonrecourse debt equal to partners' shares of such Section 704(c) minimum gain.

2. Next, determine partnership minimum gain [in excess of any Section 704(c) minimum gain] using tax-basis numbers. Allocate basis to partners equal to their shares of nonrecourse tax deductions or cash distributions that produced such minimum gain.

3. Allocate the remaining *excess* nonrecourse liabilities among the partners based on their profit sharing ratios. Such profit sharing ratios should be stipulated in the partnership agreement and should be consistent with (though not necessarily identical to) the allocation of some other significant item of partnership profit or gain that has an economic impact on the liquidation value of the partners' interests. For example, if partnership operating profits are allocated 90/10 and gain on sale 75/25, it should be permissible to use any ratio from 90/10 to 75/25 for purposes of allocating *excess* nonrecourse liabilities.

This approach complies with the spirit, if not the letter, of the Section 752 regulations.

Allocating Exculpatory Debts

Exculpatory debts are debts that are not secured by specific partnership or LLC property and no partner or member has personal liability for them. The concept of exculpatory liabilities was introduced in the Preamble to 1992 regulations dealing with how to allocate partnership nonrecourse deductions. This discussion will focus on LLCs since these entities are the ones most likely to have exculpatory debts. Most recourse debts of an LLC are exculpatory debts because the creditors have recourse against the assets of the LLC, but the members have no liability for such debts under state law. Apparently, exculpatory debts also include liabilities that are recourse to the LLC but secured by specific property (such as a recourse second mortgage on real estate). This is because such liabilities are, in effect, legally secured by all LLC assets (the lender can move against other LLC assets if the value of the specific property securing the liability proves to be inadequate). Alternatively, it may also be appropriate to consider a recourse liability secured by specific property to be a true nonrecourse debt (rather than an exculpatory debt) when the FMV of the specific collateral clearly exceeds the debt principal. In such case, the secured recourse debt is economically the same as a true nonrecourse debt because the lender need not actually look to any other LLC assets in event of a default.

The preamble to the Section 704 regulations provides that exculpatory debts are treated as nonrecourse liabilities. However, the preamble also recognizes that there may be a problem in allocating exculpatory debts under the Section 752 regulations' rules. This problem stems generally from the fact that one of the tiers used to allocate nonrecourse debts is minimum gain—a hypothetical gain calculation based on a sale of property secured by nonrecourse debt. Since exculpatory debt is not secured by specific property, it is not clear how the Section 752 regulations should apply. Consequently, the preamble states that exculpatory debts should be allocated ". . . in a manner that reasonably reflects the principles of Section 704(b)."

The only reasonable method for allocating exculpatory debts is to make a minimum gain calculation assuming that the exculpatory debt encumbers all LLC property including cash. However, where property secures true nonrecourse debt or member nonrecourse debt, the exculpatory debts are considered to be of a lower priority than the true nonrecourse or member nonrecourse debt. Reg. 1.704-2(d)(2)(ii) provides that where property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order or priority.

This method for allocating exculpatory debt is summarized in the following steps:

1. Determine minimum gain with respect to true nonrecourse debt. Then reduce the book basis of LLC assets securing true nonrecourse debts and member nonrecourse debt by the amount of those debts. If the basis of the assets securing the debt is equal to or less than the amount of the liabilities, no amount of the basis is used in the calculation of minimum gain in step 2.

2. Determine minimum gain with respect to exculpatory liabilities. Allocate the remaining book basis of LLC property to the exculpatory debts in proportion to the outstanding balance of each debt. [Reg. 1.704-2(d)(2)(ii) provides that if property is subject to more than one liability of equal priority, the property's adjusted basis is allocated among the liabilities in proportion to their outstanding balances. All exculpatory liabilities are considered to have the same priority.]

3. Allocate the total minimum gain calculated in steps 1 and 2 among the members.

4. Calculate Section 704(c) minimum gain and allocate among the members. [In certain limited circumstances, Section 704(c) minimum gain may exist with respect to exculpatory debt. In two private

letter rulings, the IRS addressed the issue of Section 704(c) minimum gain when properties subject to nonrecourse debt were transferred to a new partnership and the nonrecourse debt was replaced with other debt that was not secured by individual properties, but by all partnership properties. In these rulings, the IRS held that, in this type of situation, when determining Section 704(c) minimum gain, a partnership with unsecured financing may allocate the financing among its properties that are subject to the financing in any amount that does not exceed the lesser of (1) the FMV of the property or (2) the amount of debt previously allocated to the property and repaid with proceeds of the financing.]

5. Allocate excess nonrecourse liabilities.

Example 1J-4 Allocating exculpatory debts.

Roger and Ted form Movieland LLC to operate an online video store in 2010. Movieland is classified as a partnership for federal taxes. They both contribute $10,000 in exchange for a 50% interest in all items of LLC capital, profits, and losses. Movieland uses $10,000 of its cash and the proceeds of a $210,000 recourse note to purchase various assets. Movieland leases the building in which the operation is located. At the end of 2010, the balance of the note is $200,000 and the book basis of Movieland's property is $185,000 ($4,000 cash + $181,000 of depreciable personal property).

The $200,000 note is recourse with respect to the LLC, but the members do not have any personal liability for the obligation. Accordingly, the debt is exculpatory and is allocated under the three tier system applicable to nonrecourse debts. The first step in allocating the liabilities among the members is to determine and allocate minimum gain as follows:

Outstanding balance	$ 200,000
Book basis of property securing liability	(185,000)
Minimum gain	$ 15,000

The $15,000 of minimum gain is allocated among the members according to the rules for allocating minimum gain. The remaining nonrecourse debt of $185,000 ($200,000 − $15,000) is allocated half ($92,500) to each member based on the rules for allocating excess nonrecourse liabilities. Since both members contributed cash, there is no Section 704(c) minimum gain.

Example 1J-5 Allocating exculpatory liabilities and true nonrecourse debt.

Jane, John, and Joan form Three J's LLC. Three J's is classified as a partnership for federal taxes. Each member contributes $100,000 cash in exchange for a one-third interest in all items of LLC capital, profits, and losses. Three J's uses $200,000 of its cash and the proceeds of a $1 million nonrecourse note to buy a building. On December 31, Year 1, the LLC has $105,000 cash, investments of $200,000, and a building with an adjusted book basis of $1,185,000. The outstanding balance of the nonrecourse mortgage is $990,000 and the LLC has an outstanding short-term recourse debt of $180,000.

The $990,000 mortgage is a true nonrecourse debt. The $180,000 short-term note is an exculpatory debt. Accordingly, both debts are allocated under the three-tier system applicable to nonrecourse debts. The first step in allocating the liabilities among the members is to determine and allocate minimum gain as follows:

1. Determine minimum gain with respect to true nonrecourse debt.

Outstanding balance	$ 990,000
Adjusted book basis of property	(1,185,000)
Minimum gain	$ (195,000)

2. Determine minimum gain with respect to exculpatory liabilities.

Outstanding balance	$ 180,000
Adjusted book basis of property ($1,185,000 − $990,000) + $105,000 + $200,000	(500,000)
Minimum gain	$ (320,000)

There is no minimum gain to be allocated to the members. Since all of the members contributed cash, there is also no Section 704(c) minimum gain. Accordingly, each of the members is allocated one-third ($390,000) of the LLC's total nonrecourse debt of $1,170,000 based on the requirement to allocate excess nonrecourse liabilities according to the members' interests in LLC profits.

At the end of Year 2, the LLC still has short-term debt of $180,000, but now the balance of the nonrecourse mortgage is $950,000, the adjusted book basis of the building is $900,000, and the LLC's only other asset is $200,000 cash. The allocation of liabilities would be as follows:

1. Determine minimum gain with respect to true nonrecourse debt.

Outstanding balance	$ 950,000
Adjusted book basis of property securing debt	(900,000)
Minimum gain	$ 50,000

2. Determine minimum gain with respect to exculpatory liabilities.

Outstanding balance	$ 180,000
Adjusted book basis of property (cash)	(200,000)
Minimum gain	$ (20,000)

Now there is $50,000 of minimum gain with respect to the true nonrecourse debt, but still no minimum gain with respect to the exculpatory debt. The $50,000 minimum gain is allocated among the members according to the rules discussed earlier in this lesson and the remaining nonrecourse debt of $1,080,000 ($950,000 + $180,000 − $50,000) is allocated one-third ($360,000) to each member based on the rules for allocating excess nonrecourse liabilities.

What would happen if the nonrecourse mortgage were converted to an exculpatory debt before the end of Year 2? Minimum gain would be calculated as follows:

Outstanding balance	$ 1,130,000
Adjusted book basis of property	(1,100,000)
Minimum gain	$ 30,000

The amount of allocable minimum gain is reduced from $50,000 to $30,000 because the basis of property used to make the calculation now includes all LLC property and not just the property securing debt. As a general rule, the conversion of true nonrecourse debt to exculpatory debt may decrease the amount of LLC minimum gain.

Example 1J-6 Allocating exculpatory liabilities, true nonrecourse debt, and member nonrecourse debt.

Jerry, George, and Elaine form Vandalay LLC. Vandalay is classified as a partnership for federal taxes. Jerry contributes a building subject to a $900,000 mortgage loan. At the time of contribution, the building has a FMV of $1 million and a tax basis of $900,000 [resulting in Section 704(c) gain of $100,000]. George and Elaine each contribute $100,000 cash to the LLC. Each member has a one-third interest in all items of LLC capital, profits, and losses. After the LLC's formation, Vandalay obtains a nonrecourse second mortgage of $100,000 on the building. However, the bank insists that the loan be guaranteed by a member of the LLC. Jerry agrees to be the guarantor. On December 31, Year 1, the LLC has $75,000 cash, investments of $150,000, and a building with an adjusted book basis of $980,000 and an adjusted tax basis of $885,000. The outstanding balance of Vandalay's debt is as follows:

Nonrecourse mortgage	$ 890,000
Second mortgage	85,000
Short-term recourse debt	150,000
Total liabilities	$ 1,125,000

The $85,000 second mortgage is member nonrecourse debt, which is allocated 100% to Jerry, the guarantor member. The $890,000 mortgage is a true nonrecourse debt. The $150,000 short-term note is an exculpatory debt. Accordingly, all debts are allocated under the three tier system applicable to nonrecourse debts. The first step in allocating the liabilities among the members is to determine and allocate minimum gain as follows:

1. Determine minimum gain with respect to true nonrecourse debt.

Outstanding balance	$ 890,000
Adjusted book basis of property securing debt	(980,000)
Minimum gain	$ (90,000)

2. Determine minimum gain with respect to exculpatory liabilities.

Outstanding balance	$ 150,000
Adjusted book basis of property ($980,000 − $890,000 − $85,000) + $225,000	(230,000)
Minimum gain	$ (80,000)

There is no minimum gain to be allocated to the members.

The adjusted book basis of the property securing the exculpatory debt is the basis of the property securing the true nonrecourse debt and member nonrecourse debt ($980,000) less the balances of those debts ($890,000 + $85,000); plus the other assets of the LLC ($75,000 cash + $150,000 investments).

Next compute Section 704(c) minimum gain with respect to the true nonrecourse debt.

Outstanding balance	$ 890,000
Adjusted tax basis of property	(885,000)
Section 704(c) minimum gain	$ 5,000

An amount of debt equal to the Section 704(c) minimum gain is allocated 100% to Jerry, the member that contributed the building. The second mortgage of $85,000 is also allocated 100% to Jerry, the guarantor member. The remaining nonrecourse debt of $1,035,000 ($1,125,000 − $85,000 − $5,000) is allocated one-third ($345,000) to each member based on the rules for allocating excess nonrecourse liabilities.

Now assume that at the end of Year 4, the LLC still has short-term debt of $150,000 (for this purpose the $150,000 exculpatory debt is treated as a nonrecourse liability), but the balance of the nonrecourse first mortgage is now $850,000 and the balance of the nonrecourse second mortgage is $30,000. The adjusted book basis of the building is $800,000, and its adjusted tax basis is $750,000. The LLC's only other asset is $200,000 cash. The allocation of liabilities would be as follows:

1. Determine minimum gain with respect to true nonrecourse debt.

Outstanding balance	$ 850,000
Adjusted book basis of property securing debt	(800,000)
Minimum gain	$ 50,000

2. Determine minimum gain with respect to exculpatory liabilities.

Outstanding balance	$ 150,000
Adjusted tax basis of property (cash)	(200,000)
Minimum gain	$ (50,000)

Minimum gain of $50,000 must be allocated to the members according to the rules for allocating minimum gain discussed earlier in this lesson. Next compute Section 704(c) minimum gain with respect to the true nonrecourse debt.

Outstanding balance	$ 850,000
Adjusted tax basis of property	(750,000)
Subtotal	100,000
Less minimum gain with respect to true nonrecourse debt	(50,000)
Section 704(c) minimum gain	$ 50,000

The Section 704(c) minimum gain is allocated 100% to Jerry, the member that contributed the building. In addition, the second mortgage of $30,000 is allocated 100% to Jerry, the guarantor member. The remaining nonrecourse debt of $900,000 ($1,030,000 – $30,000 – $50,000 – $50,000) is allocated one-third ($300,000) to each member based on the rules for allocating excess nonrecourse liabilities.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. Generally, nonrecourse liabilities are allocated to partners—

    a. in the same proportion as loss interests for the partners.

    b. in the same proportion as profits interests.

    c. evenly among the partners.

    d. entirely to the partner with greatest basis.

30. A partner's share of partnership minimum gain is determined in accordance with Sec. 704(b). Which value is used in calculating minimum gain?

    a. The asset's book value.

    b. The asset's FMV.

    c. The asset's adjusted tax basis.

    d. The asset's initial basis to the partnership.

31. Describe the calculation of the second-tier Section 752 allocation under the traditional method, assuming the following facts: A 50/50 partnership was formed, with Partner A contributing depreciable property with tax basis $20,000 and FMV $50,000. The property has a $30,000 mortgage (nonrecourse) on it. The agreement calls for 50/50 allocation of all partnership items of income, gain, deduction, and loss. Section 704(b) safe harbor rules are used to maintain partnership capital accounts.

    a. Gain to Partner A is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is split evenly between the partners. Differences in partners' book and tax capital accounts are adjusted by allocation from other partnership income items.

    b. Gain to Partner B is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is split evenly between the partners. Differences in partners' book and tax capital accounts are adjusted by remedial tax loss/gain allocation from the book loss.

    c. Gain to Partner A is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is split evenly between the partners. Differences in partners' book and tax capital accounts are not adjusted.

    d. Gain to Partner B is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is allocated to partners based on their income sharing agreement. Differences in partners' book and tax capital accounts are ignored.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

29. Generally, nonrecourse liabilities are allocated to partners— **(Page 50)**

    a. in the same proportion as loss interests for the partners. [This answer is incorrect. Nonrecourse liabilities are allocated to partners, however, this answer choice does not reflect the correct basis for the allocation.]

    b. in the same proportion as profits interests. [This answer is correct. Nonrecourse liabilities are allocated to partners in accordance with their profits interest per IRS regulations. Such interests are to be determined by taking into account all the facts and circumstances relating to the partners' economic arrangement.]

    c. evenly among the partners. [This answer is incorrect. The allocation is based on profit-sharing ratios.]

    d. entirely to the partner with greatest basis. [This answer is incorrect. Allocation is based on profit-sharing agreements.]

30. A partner's share of partnership minimum gain is determined in accordance with Sec. 704(b). Which value is used in calculating minimum gain? **(Page 50)**

    a. The asset's book value. [This answer is correct. Book value is used in calculating minimum gain as defined in the IRC.]

    b. The asset's FMV. [This answer is incorrect. FMV is used to determine the partner's basis of contributed property at the time of the contribution.]

    c. The asset's adjusted tax basis. [This answer is incorrect. Adjusted tax basis is used to determine the partnership's basis in contributed property.]

    d. The asset's initial basis to the partnership. [This answer is incorrect. Calculation of minimum gain is not based on the asset's initial basis with regard to the partnership. The asset's initial basis for partnership valuation would be the asset's adjusted tax basis.]

31. Describe the calculation of the second-tier Section 752 allocation under the traditional method, assuming the following facts: A 50/50 partnership was formed, with Partner A contributing depreciable property with tax basis $20,000 and FMV $50,000. The property has a $30,000 mortgage (nonrecourse) on it. The agreement calls for 50/50 allocation of all partnership items of income, gain, deduction, and loss. Section 704(b) safe harbor rules are used to maintain partnership capital accounts. **(Page 50)**

    a. Gain to Partner A is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is split evenly between the partners. Differences in partners' book and tax capital accounts are adjusted by allocation from other partnership income items. [This answer is incorrect. This describes the traditional method with curative allocations, not the traditional method.]

    b. Gain to Partner B is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is split evenly between the partners. Differences in partners' book and tax capital accounts are adjusted by remedial tax loss/gain allocation from the book loss. [This answer is incorrect. It mixes the traditional and remedial approaches, which is improper.]

    c. Gain to Partner A is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is split evenly between the partners. Differences in partners' book and tax capital accounts are not adjusted. [This answer is correct. In this case, Partner A experiences a gain from the difference in book and tax basis, and the partnership shares the loss from book versus deemed sale proceeds at debt level.]

    d. Gain to Partner B is the difference in nonrecourse debt and tax basis of the property. Loss from the difference in book basis (FMV) of the property and deemed sale proceeds is allocated to partners based on their income sharing agreement. Differences in partners' book and tax capital accounts are ignored. [This answer is incorrect. Partner A received the gain, and allocation of the loss is incorrectly stated.]

Guarantees and Similar Arrangements

In determining the partners' relative economic risks of loss with respect to partnership liabilities for purposes of allocating basis from debt under the Section 752 rules (using the no value liquidation concept explained earlier in this lesson), the practitioner must consider all relevant arrangements among the partners and between the partners and the partnership. Such arrangements may include guarantees, indemnity agreements, and similar written or oral arrangements. It is not unusual for partnership debt to be guaranteed by one or more partners or partner affiliates. The reason for a guarantee may include the need to give the lender an easier way to collect in the event of a default (it is easier to sue one "deep pocket" than to sue all the partners) or the need to establish, for Section 752 basis purposes, some personal liability for what would otherwise be a nonrecourse loan.

Guarantee of Recourse Debt

The effect of a guarantee on partners' shares of basis from a partnership liability depends on how the guarantee affects the partners' ultimate economic risks with respect to the guaranteed debt. When the guarantee relates to what would have been recourse debt even without the guarantee, it will often have no real effect on the guarantor partner's risk of loss. The guarantee may make it easier for the creditor to collect. But, absent other contractual provisions, if the guarantor pays the debt, he will become subrogated to the creditor's rights. This means the guarantor steps into the shoes of the creditor and is, therefore, entitled to recover his debt repayment from the partnership or the other partners. In such cases, because the guarantor partner's ultimate risk with respect to the recourse debt remains unchanged even after the guarantee, the partners' shares of the recourse liability for basis purposes are not affected by the guarantee.

Guarantee of Nonrecourse Debt or When Guarantor Partner Waives Subrogation Rights

On the other hand, if the guarantee creates personal liability when there otherwise would have been none or eliminates another partner's risk with respect to the loan (for example, when a partner or partner affiliate guarantees what would otherwise be nonrecourse debt, or when a guarantee of recourse debt shifts ultimate personal liability for the indebtedness by including a waiver of subrogation or recourse against the partnership), the guarantee will have an impact on the allocation of the guaranteed debt. Thus, guarantees of nonrecourse partnership loans by a partner or a partner affiliate usually shift the basis attributable to guaranteed debt from the other partners to the guarantor (or partner affiliate of the guarantor). In effect, the guarantee causes the otherwise nonrecourse debt to be recharacterized as recourse.

De Minimis Rule

For guarantees of post-12/27/91 nonrecourse debt (or interest on nonrecourse debt), there is no recharacterization of the debt as recourse if the guarantor partner (or partner related to the guarantor) has a 10% or less interest in each item of partnership income, gain, loss, deduction, or credit for every tax year the partner is a partnership member. In addition, for this *de minimis* rule to apply, the nonrecourse loan must meet the Section 465(b)(6) at-risk definition of qualified nonrecourse financing without regard to the type of activity for which the debt is used (i.e., it need not be used in connection with real estate activities).

This favorable *de minimis* rule applies to both guarantees of nonrecourse debt principal and interest. This rule could be elected for pre-12/28/91 partnership liabilities by electing to apply the final regulations to all partnership liabilities effective with the first tax year ending after 12/27/91.

Tantamount to a Guarantee

An arrangement need not be a literal guarantee to be considered one for Section 752 purposes. If one or more partners or related persons undertake contractual obligations that substantially eliminate a creditor's risk on an otherwise nonrecourse loan, the arrangement may be considered tantamount to a guarantee—if one of the principal purposes of the contractual obligations is to circumvent the economic risk of loss principles under Reg. 1.752-2(j)(2) (Example 1K-3).

Interest Guarantees

In some cases, one or more partners (or partner affiliates) guarantee the interest on a nonrecourse debt. If such a guarantee results in personal liability for more than 25% of the total interest that accrues on the liability during its remaining term and, based on all facts and circumstances, it is reasonable to expect the guarantor partner(s) will be called upon to pay substantially all of the guaranteed interest, the liability is treated as two separate liabilities. The guarantor partner(s) are deemed to bear the economic risk of loss with respect to the present value of the guaranteed future interest payments. The expectation that the partner will have to fund the guarantee generally is reasonable if, upon a default in payment by the partnership, the lender can enforce the interest guarantee without foreclosing on the property and thereby extinguishing the underlying debt. For liabilities incurred before 12/28/91, the temporary regulations provide a more restrictive 20% of total interest rule.

Example 1K-1 Effect of partner's guarantee of partnership nonrecourse debt.

Steve, a real estate developer, wants to purchase Slimy Acres, a very desirable former toxic waste disposal site. Steve believes he can build a shopping center on the site at low cost and, after operating it several years, sell it at a considerable gain. Although Steve has significant net worth, he is cash poor, as most of his wealth is tied up in real estate. Martin, an investor, is willing to lend the cash necessary to get the project off the ground, but only in exchange for a share of the project's tax benefits and appreciation. To meet their mutual needs, Steve and Martin form Saturday Nite Joint Venture, a limited partnership. Steve is the general partner, contributing $50,000 for a 50% general partner interest, and Martin contributes $50,000 for a 50% limited partner interest. Additionally, Martin loans the partnership $2 million on an unsecured but fully recourse basis. Neither partner contributes any property other than money, and the partnership agreement does not contain a deficit capital account restoration provision. Saturday Nite Joint Venture purchases the land, obtains a construction loan, and builds the shopping center.

Following completion of the project, Saturday Nite obtains a $9 million permanent loan secured by a first mortgage and repays Martin's $2 million loan. At the partnership's insistence, the $9 million loan is structured as a nonrecourse obligation. The note and mortgage are conspicuously labeled *nonrecourse* and provide neither Saturday Nite nor its partners any personal liability for the debt in the event of a default. However, because the lender is not willing to rely solely on the real estate for repayment of the loan, Steve personally guarantees repayment of the debt through a side agreement with the lender.

By guaranteeing the debt, Steve assumes the economic risk of loss for the whole $9 million nonrecourse debt and thereby converts it into a *recourse* liability that must be allocated 100% to him. Martin is allocated no basis from the $9 million liability.

Example 1K-2 Effect of partial guarantee of nonrecourse debt.

Assume the same facts as in Example 1K-1 except Steve guaranteed the *first* $7 million of debt and Martin guaranteed the remaining $2 million (in other words, the lender could only seek recovery against Martin if the property turns out to be worth less than $2 million upon foreclosure). Steve is allocated $7 million of basis under IRC Sec. 752, and Martin is allocated $2 million of basis. The $2 million portion of the loan is deemed the superior loan, and the $7 million portion is deemed the inferior loan. Therefore, the first $7 million of loss is allocable to Steve under IRC Sec. 704(b). Martin, despite having $2 million of basis, cannot be allocated any of the losses because the Section 704(b) rules do not look to the results of a no value liquidation. Under the Section 704(b) rules, Martin has no economic risk until the basis of the property is less than $2 million.

Example 1K-3 Effect of master lease agreement on allocation of nonrecourse debt—tantamount to a guarantee.

Dickson Co. is the sole general partner of a limited partnership that leases construction equipment. The partnership has three limited partners unrelated to Dickson Co. Each has a 30% interest in profits and losses. Dickson Co. has a 10% interest in profits and losses. As part of its leasing business, the partnership purchases a bulldozer for $100,000 to lease to one of its customers. The equipment is purchased with the proceeds of a $100,000 loan from an unrelated lender.

The limited partners do not want any personal liability on the loan but want to utilize the anticipated tax deductions from the equipment's depreciation. Therefore, the partnership (without consulting its tax advisors) arranges for the $100,000 loan to be nonrecourse to the partnership and secured by the equipment. However, as a condition of the loan, Dickson Co. (which has substantial net worth) leases the equipment from the partnership under a master lease and subleases the equipment to the partnership's customer. The terms of the master lease are significantly more generous to the lessor (the partnership) than commercial conditions demand at the time the partnership enters into the lease. The partnership assigns the master lease to the lender as additional security. The rental payments due under the master lease fully service the $100,000 liability. Dickson Co.'s obligation under the master lease is unconditional.

Where (1) one or more partners (or persons related to partners) undertake a contractual obligation for the partnership to obtain a loan, (2) the obligation substantially eliminates the creditor's risk that the partnership will not meet its obligations under the loan, and (3) one of the principal purposes of the arrangement is to permit partners (other than those with the contractual obligation) to include a portion of the liability in the bases of their partnership interests, the partners with the contractual obligation are deemed to bear the economic risk of loss for such liability to the extent of their contractual obligation. This is the *tantamount to a guarantee* rule.

In this example, it seems likely one of the principal purposes of the master lease is to permit each limited partner to include a portion of the liability in his partnership interest basis. The lease is more generous to the lessor than commercial conditions demand, and the same economic results could have been obtained by simply having the lender make a recourse loan to the partnership, in which case only Dickson Co. would have been allocated basis from the liability. Therefore, Dickson Co. is treated as having an economic risk of loss with respect to the liability, the liability is treated as recourse, and only Dickson Co. is allocated any of the liability for basis purposes.

Transactions That Reallocate Partnership Liabilities

Because partnership liabilities can affect the tax results of almost any transaction involving a partnership and its partners, the allocation of partnership liabilities can provide planning opportunities—but also can create traps for the unwary. The following paragraphs identify several transactions that can cause unexpected shifts in the allocations of partnership liabilities for basis purposes.

Contributions and Distributions of Encumbered Property

Contributions of property subject to indebtedness involve a constructive cash distribution (and possible gain recognition) to the contributor and constructive cash contributions and basis increases for other partners. Distributions of encumbered property involve a constructive cash contribution and basis increase for the distributee and constructive distributions and possible gain recognition to other partners.

Changes in Profit and Loss Sharing Ratios and Admission of New Partners

Because the sharing of partnership liabilities is directly related to the partners' profit interests (for nonrecourse liabilities) and loss interests (for recourse liabilities), a change in partnership sharing ratios almost invariably results in a corresponding change in shares of partnership liabilities. The constructive cash contributions and distributions accompanying such shifts are not always anticipated but can have significant consequences—especially for any partner whose share of liabilities is reduced. Admitting a new partner generally results in a reduction in the share of liabilities of any original partner whose share of losses and profits is reduced. Thus, the original partner is deemed to have received a constructive cash distribution.

Payment of Partnership Liabilities

A partnership's payment of a liability to a creditor is treated as a constructive distribution to partners who shared in that liability. If such payments are made from partnership income, the basis increases and decreases from the income and payments generally offset each other. But, if the partners share the income and the liability in different percentages (e.g., because of special allocations or because the debt is a recourse debt of a limited partnership), the bases of some partners may be increased, while others are decreased from the combination of the two transactions. It is even possible a partner could recognize capital gain if the reduction of liabilities results in the deemed distribution of an amount exceeding the basis of his partnership interest.

Changes in Partnership Minimum Gain

Changes in a partner's share of partnership minimum gain can alter his share of nonrecourse debt for basis purposes.

Changes in Partner or Partnership Status from General to Limited or Vice Versa

On occasion, partners may find it desirable to convert a partnership from a limited to a general partnership or vice versa, or for one or more partners to change their status. This could be occasioned by a need for new capital investment or other financing for the partnership's business, as a response to the passive activity loss limitations, or for other reasons. A partnership converted from a general partnership to a limited partnership, or vice versa, is treated as a continuation of the same partnership for federal income tax purposes. However, because of the differences in the way general and limited partners share liabilities, such changes are usually accompanied by shifts in liability sharing, which, in turn, produce the constructive contributions and distributions discussed earlier in this lesson. Likewise, a conversion from a general partnership to an LLC is treated as a continuation of the partnership for federal tax purposes, assuming the LLC is classified as a partnership for federal tax purposes. Thus, the principles of Rev. Rul. 84-52 will apply in that situation as well.

Many state statutes now permit "formless" conversions from partnerships to LLCs or vice versa. Under those statutes, there are no requirements to retitle assets, etc.; the conversion automatically covers all of those legal points. However, from a tax perspective, the conversion of a general or limited partnership interest in a limited partnership to an LLC or vice versa normally creates a shift in liabilities, producing constructive contributions and distributions to the partners or members.

Exchanging Partnership Property

IRC Sec. 1031 postpones the recognition of gain or loss by allowing the simultaneous or deferred exchange of like-kind property held for business or investment purposes. The Section 1031 regulations allow the taxpayer to offset the liabilities assumed on the property received in a like-kind exchange by the liabilities the taxpayer was relieved of on the property given up.

Deferred like-kind exchanges pose another layer of problems, especially when the replacement property is acquired in the tax year following the initial property disposition. Through Rev. Rul. 2003-56, the IRS has taken a practical approach to the adjustment of the partners' interests in partnership liabilities resulting from the exchange. The transaction is essentially treated as an open transaction until the replacement property is acquired and the exchange is completed (or the transaction fails because the requirements of IRC Sec. 1031 are not met).

In general, if a partnership enters into a like-kind exchange that straddles two tax years, the liabilities attached to the relinquished and replacement properties are netted to determine whether there is any net increase or decrease in a partner's share of partnership liabilities. If there is a net decrease, this, and the accompanying deemed distribution are deemed to have occurred in the taxable year of the initial disposition, with the deemed distribution being treated as an advance or draw against the partner's share of partnership income for the year (Rev. Rul. 94-4). The income for that year will include any gain recognized by the partnership on the initial disposition. [If the like-kind exchange is never consummated (or fails to qualify), these results occur as of the initial disposition.]

If there is a net increase in a partner's share of liabilities, this and the related deemed contribution and basis increase are deemed to occur at the time of the receipt of the replacement property.

If the liabilities involved are both nonrecourse, the partnership's minimum gain on the last day of the year of the initial disposition is determined by reference to the replacement property and the replacement nonrecourse liability.

How to Apply the Regulations on Liability Assumptions

In 2005, the Treasury issued regulations addressing abusive transactions involving the contribution of liabilities to a partnership and subsequent disposition of the partnership interest. These transactions accelerate or duplicate losses through the assumption of (or transfer of assets subject to) liabilities. An example of such an arrangement involves a taxpayer's borrowing at a premium and a partnership's subsequent assumption of that debt. For example, a taxpayer may receive $5,000 cash from a lender under a loan agreement that provides a stated principal amount of $4,000 and an inflated rate of interest. The taxpayer contributes the $5,000 to a partnership and the partnership assumes the $4,000 debt. At a later time, the taxpayer sells his partnership interest. The taxpayer claims that only the $4,000 principal amount of the debt is assumed by the partnership, resulting in the taxpayer having a basis in his partnership interest of $1,000—the $5,000 cash contributed, less the $4,000 deemed distribution of cash from the assumption of the taxpayer's debt by the partnership. Upon disposition, the taxpayer claims a loss of $1,000, even though he has incurred no corresponding economic loss. In another variation of this transaction, taxpayers use put and call options to achieve substantially the same result.

The regulations, which generally apply to assumptions of Reg. 1.752-7 liabilities occurring on or after 6/24/03, provide rules to prevent the duplication and acceleration of loss through the assumption by a partnership of a Reg. 1.752-7 liability from a partner. A Reg. 1.752-7 liability is defined as any fixed or contingent liability that is not described in Reg. 1.752-1(a)(4)(ii), to the extent that either the obligation is not described in that regulation, or the amount of the obligation exceeds the amount taken into account under Reg. 1.752-1(a)(4)(i). Reg. 1.752-1(a)(4)(ii) defines an obligation as any fixed or contingent obligation to make payment regardless of whether the obligation is otherwise taken into account under the Internal Revenue Code. Obligations include debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. Reg. 1.752-1(a)(4)(ii) goes on to provide that an obligation is a liability for the purposes of IRC Sec. 752 only if and to the extent the obligation:

1. creates or increases the basis of any of the obligor's assets (including cash);
2. gives rise to an immediate deduction to the obligor; or
3. gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital (such as a penalty, or the nondeductible portion of meals and entertainment expenses).

Determining the Amount of a Reg. 1.752-7 Liability

The amount of a Reg. 1.752-7 liability or obligation is the amount of cash a willing assignor would pay a willing assignee to assume the liability or obligation in an arm's-length transaction. If the obligation arose under a contract in exchange for rights granted to the obligor under that contract, and those rights are contributed to a partnership in connection with its assumption of the contractual obligation, the amount of the liability or obligation is the amount of cash a willing assignor would pay a willing assignee to assume the whole contract. A partner's share of a partnership's Reg. 1.752-7 liability is the amount of the deduction that would be allocated to the partner if the partnership disposed of all of its assets, satisfied all its liabilities other than Reg. 1.752-7 liabilities, and paid an unrelated person to assume all of its Reg. 1.752-7 liabilities in a fully taxable arm's-length transaction (assuming such payment would give rise to an immediate deduction).

Example 1M-1 Valuing Reg. 1.752-7 liabilities.

Moe, Larry, and Curly form the Poked Eye Partnership. Curly contributes $100,000 for a 25% partnership interest plus the partnership's assumption of an obligation with an issue price and a stated redemption price of $50,000. The obligation was issued for cash and bears interest at a fixed rate of interest (payable quarterly) that was a market rate when the obligation was issued. At the time the partnership assumed the obligation, all interest payments were current. Prior to the assumption of the obligation by the partnership, interest rates decreased, resulting in the obligation carrying an above-market rate of interest. (Because of this, Curly would have had to pay an assignee $60,000 to assume the debt obligation.) The assumption of the obligation by the partnership is treated as the assumption of a $50,000 regular Section 752 liability (the portion that created basis) and a $10,000 Reg. 1.752-7 liability.

Contributing Reg. 1.752-7 Liabilities

The regulations address how Reg. 1.752-7 liabilities are treated when they are assumed by a partnership as part of a tax-free contribution by a partner, when a partner other than the contributing partner assumes part or all of the liability from the partnership, and when the contributing partner subsequently sells or exchanges all or part of his partnership interest or receives a distribution in liquidation of his partnership interest. The regulations prevent the duplication of loss by prohibiting the partnership and any person other than the contributing partner from claiming a deduction or capital expense to the extent of the built-in loss associated with the obligation. The regulations also prevent the acceleration of loss by deferring the contributing partner's deduction or loss attributable to the obligation until economic performance occurs.

It is important to note that, under certain circumstances, the subsequent transfer of the contributor's partnership interest, the liquidation of the contributor's partnership interest, or the assumption of the transferred liability by another partner does not trigger the application of the Reg. 1.752-7 rules. The first exception applies if a partnership assumes a Reg. 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business. If a partnership (upper-tier entity) assumes a Reg. 1.752-7 liability of a partner, and, subsequently, another partnership (lower-tier entity) assumes that Reg. 1.752-7 liability from the upper-tier entity, then the Reg. 1.752-7 liability is treated as associated only with any trade or business contributed to the upper-tier entity by the contributing partner. The second exception applies when, immediately before the testing date, the remaining built-in loss on all Reg. 1.752-7 liabilities assumed by the partnership (except those assumed in connection with an associated trade or business) in one or more Reg. 1.752-7 liability transfers is less than the lesser of 10% of the partnership's gross value or $1 million. The testing date is the date of a sale, exchange, or other disposition of part or all of the Reg. 1.752-7 liability partner's interest; the date of the partnership's distribution in liquidation of the Reg. 1.752-7 liability partner's interest; or the date of the assumption (or partial assumption) of the Reg. 1.752-7 liability by a partner other than the Reg. 1.752-7 liability partner.

Transfer of Interest by Partner Contributing Reg. 1.752-7 Liabilities

When a partnership assumes a partner's liability in connection with a property contribution to the partnership, the assumed liability is treated as having a built-in loss under the rules of IRC Sec. 704(c). The amount of the built-in loss is the amount of the Reg. 1.752-7 liability on the date it is assumed by the partnership. Consequently, items of deduction or loss on the liability must be allocated first to the contributing partner to the extent of the built-in loss. Remaining deductions or losses are allocated among the other partners based on the Section 704(b) allocation rules.

A decrease or increase in the value of a Reg. 1.752-7 liability after it is contributed to the partnership is an item of income or loss if it is reflected in the partners' capital accounts. This income or loss is allocated among the partners based on the general rules for allocating income and loss outlined in IRC Sec. 704(b).

Additionally, the transfer of part or all of the partnership interest of a partner who contributed Reg. 1.752-7 liabilities in a nonrecognition transaction is not treated as a transfer under the final regulations. For this purpose, a nonrecognition transaction is a transaction in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the partnership interest. In addition, the transfer provisions of the regulations do not apply to a distribution of an interest in a partnership that has assumed the Reg. 1.752-7 liability by a partnership that is the contributing partner.

Example 1M-2 Transfer of partnership interest by partner contributing Reg. 1.752-7 liabilities.

In 2010, Lance, Jan, and Hunter form French Investors Partnership. Lance contributes property not associated with a trade or business for a 25% interest in the partnership. The property has a $5 million FMV, a $4 million basis and is subject to a Reg. 1.752-7 liability of $2 million. Jan contributes $3 million cash for a 25% interest and Hunter contributes $6 million for a 50% interest.

In 2012, when French has a Section 754 election in effect, Lance sells his interest to Miguel for $3 million. At the time of the sale, the basis of Lance's interest is $4 million, the remaining built-in loss associated with the Reg. 1.752-7 liability is $2 million, and French has no other liabilities. In 2013, French satisfies the outstanding Reg. 1.752-7 liability with a $3 million payment.

Lance's basis in his French interest is reduced to $3 million immediately before the sale of his partnership interest [i.e., the lesser of (1) the excess of Lance's $4 million basis over the $3 million adjusted value of that interest ($1 million), or (2) the $2 million remaining built-in loss associated with the liability contributed by Lance]. Accordingly, Lance recognizes no gain or loss on the sale of his interest to Miguel. Miguel's share of the adjusted basis of partnership assets equals his interest in the partnership's previously taxed capital of $2 million. Consequently, the basis adjustment under IRC Sec. 743(b) is $1 million.

After the sale of Lance's partnership interest, neither French nor any of its partners are entitled to a deduction for the economic performance of the Reg. 1.752-7 liability remaining in the partnership to the extent of the remaining $2 million built-in loss associated with the liability. French is entitled to a deduction, however, for the amount by which the cost of satisfying the liability exceeds the remaining built-in loss. Accordingly, in 2013, French can deduct $1 million of the cost of satisfying the liability originally contributed by Lance. If French notifies Lance that the liability was satisfied, Lance is entitled to an ordinary deduction in 2013 of $1 million (the Reg. 1.752-7 liability reduction).

Liquidating Distribution to Partner Contributing Reg. 1.752-7 Liabilities

The regulations provide rules similar to those applicable to interest transfers by partners who contributed Reg. 1.752-7 liabilities to a partnership for liquidating distributions to such partners. If a partner's Reg. 1.752-7 liability is assumed by the partnership and that partner subsequently receives a liquidating distribution, special rules apply. Immediately before the distribution, the contributing partner's partnership basis is reduced by the "Reg. 1.752-7 liability reduction." This rule applies before the Section 737 rules, which provide for the recognition of precontribution gain on certain property distributions to partners who previously contributed appreciated property to the partnership. No deduction or capital expense is allowed to the partnership on the economic performance of the Reg. 1.752-7 liability to the extent of any remaining built-in loss associated with the liability. Also, the remaining built-in loss associated with the Reg. 1.752-7 liability is not treated as a nondeductible expense and, accordingly, does not decrease the bases or capital accounts of the remaining partners. If the partnership (or any successor) notifies the contributing partner of the economic performance of the Reg. 1.752-7 liability after the sale of his interest, then the contributing partner is entitled to a loss or deduction. The deduction or loss is, in the case of a partial satisfaction of the liability, the amount the partnership paid to satisfy the liability (but not more than the Reg. 1.752-7 liability reduction previously described) or, in the case of complete satisfaction of the liability, the remaining Reg. 1.752-7 liability reduction. The character of the deduction or loss is determined as if the contributing partner had satisfied the liability. To the extent the Reg. 1.752-7 liability reduction exceeds the amount paid to satisfy the liability, the character of the partner's loss is capital.

There are two exceptions to applying the regulations to a liquidating distribution. First, if the partnership assumes the Reg. 1.752-7 liability as part of a contribution of a trade or business with which the liability is associated, and the partnership continues to carry on that trade or business, the regulations do not apply (the "trade or business exception"). Second, if immediately before the liquidating distribution part or all of the contributing partner's partnership interest [the remaining built-in loss with respect to all Reg. 1.752-7 liabilities assumed by the partnership (other than those assumed by the partnership with an associated trade or business)] is lesser than 10% of the gross value of partnership assets or $1 million, the regulations do not apply (the *de minimis* exception).

<u>Assumption of Reg. 1.752-7 Liability by a Partner Other Than the Contributing Partner.</u> The regulations provide special rules when a Reg. 1.752-7 liability is assumed from the partnership by a partner other than the contributing partner. If the contributing partner remains a partner, then his basis in the partnership is reduced by the Reg. 1.752-7 liability reduction. If the assuming partner (or any successor) notifies the contributing partner of the economic performance of the Reg. 1.752-7 liability, the contributing partner is entitled to a deduction or loss. The deduction or loss is, in the case of a partial satisfaction of the liability, the amount the partnership paid to satisfy the liability (but not more than the Reg. 1.752-7 liability reduction described in the preceding paragraph) or, in the case of complete satisfaction of the liability, the remaining Reg. 1.752-7 liability reduction. The character of the deduction

or loss is determined as if the contributing partner had satisfied the liability. To the extent the Reg. 1.752-7 reduction exceeds the amount paid satisfy the liability, the character of the partner's loss is capital.

Immediately after a partner other than the contributing partner assumes the Reg. 1.752-7 liability from the partnership, the partnership must reduce the partnership assets' basis by the remaining built-in loss associated with the liability. This basis reduction is allocated among partnership assets as if it were a Section 734(b) basis adjustment.

No deduction or capital expense is allowed to an assuming partner (other than the contributing partner) on the economic performance of a Reg. 1.752-7 liability assumed from a partnership to the extent of the remaining built-in loss associated with the liability. Instead, on economic performance of the liability, the assuming partner must adjust his partnership interest basis, any assets (other than cash, accounts receivable, or inventory) distributed by the partnership to him, or gain or loss on the disposition of his partnership interest, as the case may be. These adjustments are determined as if the assuming partner's partnership basis at the time of the assumption were increased by the lesser of (1) the amount paid to satisfy the liability, or (2) the remaining built-in loss associated with the liability. However, the assuming partner cannot take into account any adjustments to depreciable basis, reduction in gain, or increase in loss until economic performance of the liability occurs. Any adjustment to the basis of any asset under this provision is taken into account over the recovery period of the asset.

Notification Requirements. A partnership (or successor) must attach a statement to the contributing partner's Schedule K-1 for the year in which the loss is being claimed that notifies the partner the economic performance of the Reg. 1.752-7 liability has occurred. The statement must include:

1. The amount paid in satisfaction of the Reg. 1.752-7 liability, and whether the amounts paid were in partial or complete satisfaction of the debt.

2. The name and address of the person satisfying the liability.

3. The date of payment of the liability.

4. The character of the loss with respect to the liability.

Tiered Ownership Structures. A partner's contribution of a partnership interest (lower-tier entity) to another partnership (upper-tier entity) is treated as a contribution of the partner's share of each of the lower-tier entity's assets and an assumption by the upper-tier entity of the partner's share of the lower-tier entity's liabilities. If an upper-tier entity assumes a Reg. 1.752-7 liability of a partner, and, subsequently a lower-tier entity assumes that liability, the liability is treated as associated only with any trade or business contributed to the upper-tier entity by a contributing partner.

If a transfer, liquidating distribution, or assumption (by a partner other than the contributing partner) occurs with respect to an upper-tier entity that contributed a Reg. 1.752-7 liability to a lower-tier entity, it is treated as a transaction with respect to the partners of the upper-tier entity, regardless of whether the upper-tier entity actually assumed the Reg. 1.752-7 liability. The partners in the upper-tier entity at the time of the transaction are entitled to the loss or deduction on the economic performance liability.

If, after a transfer, liquidating distribution, or assumption (by a partner other than the contributing partner) subject to the regulations, another partnership or corporation assumes the liability from the upper-tier partnership (or assuming partner) in a transaction in which the basis of property is determined, in whole or in part, by reference to the basis of the property in the hands of the partnership (or assuming partner), then:

1. The upper-tier entity (or assuming partner) must reduce its basis in any corporate stock or LLC or partnership by the remaining built-in loss associated with the liability (but the members or partners in the upper-tier entity do not reduce their bases or capital accounts); and

2. No deduction or capital expense is allowed to the assuming LLC, partnership, or corporation on the economic performance of the liability to the extent of the remaining built-in loss associated with the liability.

Similar rules apply to subsequent assumptions of the Reg. 1.752-7 liability in transactions in which the basis of property is determined, in whole or in part, by reference to the basis of the property in the hands of the transferor.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. A true nonrecourse debt is guaranteed by a partner. What is the consequence of the guarantee?

    a. No consequence. The guarantee does not change the character of the debt.

    b. It negates the nonrecourse nature of the debt, so all partners share in the liability.

    c. It negates the nonrecourse nature of the debt and shifts it to the partners who did not guarantee the debt.

    d. It converts the nonrecourse debt to recourse debt and the guarantor assumes all risk of loss on it.

33. Regarding liability assumptions, and the guidance in Reg. 1.752-(a)(4)(ii), which of the following is a liability for the purposes of IRC Sec. 752?

    a. An obligation that decreases the basis of an obligor's assets.

    b. An obligation that gives the obligor an immediate deduction.

    c. An obligation that is an expense for the obligor.

34. A partnership is formed with three partners. Partner A contributed property for a 25% partnership interest. The property was not trade or business property, has FMV of $2.5 million, basis of $2 million, and is subject to a Reg. 1.752-7 liability. Partner B contributed $1.5 million cash for a 25% interest, and Partner C contributed $3 million for 50% interest. Two years later, after the partnership has made a Sec. 754 election, Partner A sells his interest to a person outside the partnership for $1.5 million. At that time, Partner A's basis is $2 million, the built-in loss remaining with the Reg. 1.752-7 liability is $1 million, and the partnership has no other liabilities. The partnership pays off the outstanding Reg. 1.752-7 liability of $1.5 million. What is the deduction available to the partnership?

    a. A deduction for the economic performance of the Reg. 1.752-7 liability remaining in the partnership.

    b. A deduction for the economic performance of the Reg. 1.752-7 liability remaining to the extent of that liability's remaining built-in loss.

    c. A deduction for the amount of the sale of Partner A's interest that exceeded Partner A's basis in the partnership.

    d. A deduction for the amount the cost of satisfying the liability exceeded the built-in loss.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. A true nonrecourse debt is guaranteed by a partner. What is the consequence of the guarantee? **(Page 61)**

    a. No consequence. The guarantee does not change the character of the debt. [This answer is incorrect. The guarantee converts the nature of the debt to recourse.]

    b. It negates the nonrecourse nature of the debt, so all partners share in the liability. [This answer is incorrect. The guarantor assumes all economic risk of loss on the debt.]

    c. It negates the nonrecourse nature of the debt and shifts it to the partners who did not guarantee the debt. [This answer is incorrect. There is a shift in the responsibility for the debt, however the shift is not to the partners who did not guarantee the debt.]

    d. It converts the nonrecourse debt to recourse debt and the guarantor assumes all risk of loss on it. [This answer is correct. Because the guarantor assumes economic risk of loss on the guaranteed debt, the debt becomes the obligation of the partner guaranteeing it, rather than that of all of the partners.]

33. Regarding liability assumptions, and the guidance in Reg. 1.752-(a)(4)(ii), which of the following is a liability for the purposes of IRC Sec. 752? **(Page 61)**

    a. An obligation that decreases the basis of an obligor's assets. [This answer is incorrect. An obligation is considered a liability for the purposes of IRC Sec. 752 only if and to the extent that it creates or increases the basis of any of the obligor's assets (including cash).]

    b. An obligation that gives the obligor an immediate deduction. [This answer is correct. According to Reg. 1.752-(a)(4)(ii), an obligation is a liability for the purposes of IRC Sec. 752 only if and to the extent that it does one of three things. One of the three situations is when an obligation gives rise to an immediate deduction to the obligor.]

    c. An obligation that is an expense for the obligor. [This answer is incorrect. An obligation is a liability for IRC Sec. 752 purposes only if and to the extent that it gives rise to an expense that is not deductible in computing the obligor's taxable income and is not property chargeable to capital (such as a penalty or the nondeductible portion of meals and entertainment expenses).]

34. A partnership is formed with three partners. Partner A contributed property for a 25% partnership interest. The property was not trade or business property, has FMV of $2.5 million, basis of $2 million, and is subject to a Reg. 1.752-7 liability. Partner B contributed $1.5 million cash for a 25% interest, and Partner C contributed $3 million for 50% interest. Two years later, after the partnership has made a Sec. 754 election, Partner A sells his interest to a person outside the partnership for $1.5 million. At that time, Partner A's basis is $2 million, the built-in loss remaining with the Reg. 1.752-7 liability is $1 million, and the partnership has no other liabilities. The partnership pays off the outstanding Reg. 1.752-7 liability of $1.5 million. What is the deduction available to the partnership? **(Page 65)**

    a. A deduction for the economic performance of the Reg. 1.752-7 liability remaining in the partnership. [This answer is incorrect. In accordance with Reg. 1.752-7, no deduction is allowed for the economic performance of the liability.]

    b. A deduction for the economic performance of the Reg. 1.752-7 liability remaining to the extent of that liability's remaining built-in loss. [This answer is incorrect. Reg. 1.752-7 does not allow the partnership a deduction for the built-in loss of the liability.]

    c. A deduction for the amount of the sale of Partner A's interest that exceeded Partner A's basis in the partnership. [This answer is incorrect. This transaction took place outside the partnership.]

    d. A deduction for the amount the cost of satisfying the liability exceeded the built-in loss. [This answer is correct. Per IRS regulations, the deduction the partnership is permitted is the cost the partnership incurred that exceeded the built-in loss of the Reg. 1.752-7 liability.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (T65TG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following occurs when a partner receives a cash distribution that exceeds that partner's outside basis?

   a. A loss is recognized by the partner.

   b. A loss is recognized on the partnership books.

   c. The partner will recognize a loss that reduces the partner's outside basis to less than zero.

   d. The partner recognizes a gain.

2. A partner has an outside basis of $60 in his partnership interest and receives a distribution of equipment with a $100 basis. The partnership does not have a Section 754 election in place. After the distribution—

   a. the partner's outside basis is ($40).

   b. the partner's outside basis is $120.

   c. the partner's outside basis is the same as inside basis.

   d. the partner's basis in that asset is $60.

3. A partner has an outside basis of $30 and receives equipment with an inside basis of $50. The partnership does not have a Section 754 election in place. After the distribution,

   a. the partner's outside basis is ($20).

   b. the partner's outside basis is $60.

   c. the partner's outside basis is the same as inside basis.

   d. the partner's basis in that asset is $30.

4. A partner may acquire a partnership interest in exchange for services that have been provided the partnership. When that happens and the partner recognizes taxable income for the service, the partner's initial basis is which of the following?

   a. The amount of taxable compensation recognized for the services.

   b. Zero.

   c. A proportion of FMV of services provided to the partnership relative to the partner's percentage interest share.

   d. Not determinable from the information given.

5. When a partnership interest is acquired by inheritance, the basis of the beneficiary is which of the following?

   a. The same as the basis of the decedent.

   b. Zero.

   c. FMV at date of death or alternate valuation date.

   d. The stepped-up basis of the decedent at date of death.

6. If a new partner's basis is stepped-up by election under IRC Sec. 754 by the partnership, what happens to income from the subsequent sale of assets?

   a. Income from sale proceeds is allocated to partners in accordance with the basis of each.

   b. Income from sale proceeds is allocated to partners other than the partner who benefited from the stepped-up basis.

   c. Income from sale proceeds is entirely allocated to the partner whose basis was stepped up, to the extent of the total step-up in basis.

   d. Income from sale proceeds is reduced by the stepped-up amount, allocated to the partner with stepped-up basis.

7. A and B form a 50/50 partnership. A contributes $25,000 cash and B contributes $5,000 cash and a personal note for $20,000. If the note is treated by the partnership as zero-basis property, what is the balancing entry?

   a. A credit to deferred contribution.

   b. A debit to deferred contribution.

   c. A credit to A's equity account.

   d. A debit to A's equity account.

8. A and B form an equal partnership. A contributes $50,000 cash. B contributes $25,000 cash and land with FMV $55,000. The land is subject to a mortgage of $30,000 and has adjusted basis of $37,500. What is B's initial outside basis in his partnership interest?

   a. $25,000.

   b. $47,500.

   c. $62,500.

   d. $80,000.

9. A and B form an equal partnership. A contributes $10,000 cash. B contributes $5,000 cash and land with FMV $11,000. The land is subject to a mortgage of $6,000 and has adjusted basis of $7,500. What is A's initial outside basis?

   a. $5,000.

   b. $9,500.

   c. $13,000.

   d. $16,000.

10. A partner's initial outside basis is decreased by which of the following?

    a. Allocation of oil and gas property depletion to partners' accounts.

    b. Additional contributions of money, property, or taxable services to the partnership.

    c. Allocation of tax-exempt partnership income.

    d. Percentage depletion deductions exceeding adjusted basis in depletable property.

11. A 50/50 partnership is formed in which partner A contributes $1,000 and partner B contributes property with FMV $1,000 and adjusted basis of $500. What is each partner's basis after adjustment for operations, if net income is $5,000?

    a. Partner A's basis is $6,000; Partner B's basis is $6,000.

    b. Partner A's basis is $3,500; Partner B's basis is $3,500.

    c. Partner A's basis is $5,000; Partner B's basis is $5,500.

    d. Partner A's basis is $3,500; Partner B's basis is $3,000.

12. A 70/30 partnership is formed in which partner A contributes $2,500 and partner B contributes property with FMV $2,500 and adjusted basis of $1,250. What is each partner's basis after adjustment for operations, if net income is $12,500?

    a. Partner A's basis is $15,000; Partner B's basis is $15,000.

    b. Partner A's basis is $8,750; Partner B's basis is $8,750.

    c. Partner A's basis is $12,500; Partner B's basis is $13,750.

    d. Partner A's basis is $11,250; Partner B's basis is $5,000.

13. An equal general partnership is formed with partner A contributing $5,000 cash and partner B contributing property with adjusted basis of $3,000 and FMV $5,000. Near the end of the first year, some of the contributed property was sold. The sold property had a depreciated basis of $900 and FMV $2,000, and was sold for $1,900. Depreciation recapture income of $1,000 was realized on the sale. During the first year's operation, the partnership had net ordinary income of $27,000, realized capital loss of $400 in short-term investments, and paid $300 in key man life premiums. Each partner received $12,000 in cash distributions during the year. Basis adjustments for each partner are identical, except that the gain on sale of contributed property is allocated solely to partner B. In year two, partner A contributed an additional $5,000 cash and the partnership had $11,000 in operating losses. What is partner A's adjusted basis at the end of year two?

    a. $5,000.

    b. $5,500.

    c. $5,650.

    d. $6,150.

14. An equal general partnership is formed with partner A contributing $2,500 cash and partner B contributing property with adjusted basis of $1,500 and FMV $2,500. Near the end of the first year, some of the contributed property was sold. The sold property had a depreciated basis of $450 and FMV $1,000, and was sold for $950. Depreciation recapture income of $500 was realized on the sale. During the first year's operation, the partnership had net ordinary income of $13,500, realized capital loss of $200 in short-term investments, and paid $150 in key man life premiums. Each partner received $6,000 in cash distributions during the year. Basis adjustments for each partner are identical, except that the gain on sale of contributed property is allocated solely to partner B. In year two, partner A contributed an additional $2,500 cash and the partnership had $5,500 in operating losses. What is partner B's adjusted basis at the end of year one?

    a. $2,500.

    b. $2,575.

    c. $2,750.

    d. $3,075.

15. Reg. 1.705-2 affects corporate partners when that corporation's stock is owned, then sold by the partnership. How is the regulation applied when there is no Section 754 election in effect for the partnership?

    a. The regulation prevents adjustment of partnership interest basis by the corporate partner.

    b. The regulation is designed to limit the increase in basis to the amount of Section 1032 gain that the corporation would have realized had a Section 754 election been made.

    c. The regulation allows recognition of gain by increasing the partnership interest basis by the amount of Section 1032 gain that the corporation would have realized had a Section 754 election been made.

    d. The regulation has no effect on recognition of gain, rather it limits the number of corporate partners in a partnership.

16. A partner's outside basis in the partnership is $3,000. The partner's share of taxable loss is $4,800. Describe the adjustments to the partner's basis.

    a. The partner's basis is reduced by $4,800.

    b. The partner's basis is unchanged and the loss recognition deferred until the partnership makes sufficient profit to make up for the loss.

    c. The partner's basis is reduced to zero and the balance of $1,800 is deferred until basis is increased.

    d. The partner's basis is reduced by $1,800 and the balance of $3,000 is deferred until there is sufficient profit to offset.

17. A partner's outside basis in the partnership is $4,500. The partner's share of taxable loss is $7,200. What occurs with this partner's capital account?

    a. The partner's basis is reduced to $0.

    b. The loss recognition is deferred.

    c. When the partnership makes sufficient profits to offset the deferred loss, the partner's basis will increase.

    d. Do not select this answer choice.

18. Partners' outside basis in his partnership interest is affected by a variety of restrictions on deductions for partnership losses, but generally—

    a. Partners can deduct the full amount of partnership losses.

    b. Partners cannot deduct partnership losses.

    c. Even if deduction is limited, basis is reduced by full amount of the loss.

    d. Partnerships do not pass losses through to partners.

19. A partner's outside basis in his partnership interest at the beginning of the year is $2,000. Partnership losses allocated to this partner were ordinary losses of $1,100 and capital losses of $300. A draw of $1,200 was distributed to the partner during the year. How much of the loss will the partner be able to claim?

    a. $300.

    b. $800.

    c. $1,100.

    d. $1,400.

20. A partner's outside basis at the beginning of the year is $1,500. There were no partnership losses allocated to this partner during the year. However, there were capital losses of $825. This partner took a draw of $900 which was distributed during the year. This partner also made a capital contribution of $50. How much of the capital loss will carry forward until there is adequate basis to claim the deduction?

    a. $0.

    b. $175.

    c. $650.

    d. $825.

21. A partner has an outside basis in his partnership interest of $700, and is allocated a Year 1 net loss of $1,000. The loss includes $100 of Sec. 179 expense and a $300 passive activity loss. The rest of the loss is from other operations of activity in which the taxpayer materially participates, including $200 of AMT preference for depreciation. The partner chooses to use the pro-rata approach for determining the identity of deductible items. How much of the Section 179 loss is deducted in the current year?

    a. $100.

    b. $90.

    c. $70.

    d. $30.

22. A partner with an outside basis of $2,100 is allocated a Year 1 net loss of $3,000. Included in the loss is $300 Sec 179 expense, $900 passive activity loss, and $1,800 from other operations in which the taxpayer materially participates. The partner also has $600 of AMT preference for a depreciation deduction. If the pro-rata approach for determining the identity of deductible items is used by the partner, how much of the Section 179 loss is reported in the current year?

    a. $300.

    b. $270.

    c. $210.

    d. $90.

23. Partner A has, at the beginning of the year, an outside basis of $10,000 in his partnership interest. Partner B has an $18,000 basis in his partnership interest. A Section 754 election is not in place and there is no net income or loss for the year. A distribution of $5,000 cash and stock with FMV of $14,000 was made to each partner at year end. The partnership's tax basis in the stock received by each partner is $8,000. Assume the distribution of marketable securities does not have to be treated as a distribution of cash. What is Partner B's ending outside basis in his partnership interest?

    a. ($1,000).

    b. $5,000.

    c. $9,000.

    d. $11,000.

24. A partnership has two general partners and one limited partner. The limited partner loans the partnership, on a nonrecourse basis, $60,000. Economic risk of loss for the loan is—

    a. Divided among the partners based on their share of income.

    b. Split between the general partners, excluding the limited partner.

    c. Retained by the limited partner.

    d. Recorded at the partnership level and is not reflected in partners' basis.

25. Crisco purchased an asset used in his sole proprietorship for $235,000 and subject to a $150,000 nonrecourse mortgage. Later, Crisco formed an equal partnership with Seco, and the partnership bought the asset from Crisco for $200,000. Payment was $37,500 in cash, and a $162,500 nonrecourse promissory note secured by the property and owed to Crisco. The $162,500 wraparound note wraps around Crisco's existing $150,000 nonrecourse note. Which of the following is true in regard to the partnership's $162,500 obligation?

    a. The $162,500 is allocated to Crisco as recourse debt.

    b. None of the $162,500 is considered recourse debt, because it was nonrecourse in the first place.

    c. $12,500 is true nonrecourse debt and $150,000 is allocated entirely to Crisco as recourse debt.

    d. $150,000 is true nonrecourse debt and $12,500 is allocated entirely to Crisco as recourse debt.

26. Jones purchased an asset used in his sole proprietorship for $47,000 and subject to a $30,000 nonrecourse mortgage. Later, Jones formed an equal partnership with Wesson, and the partnership bought the asset from Jones for $40,000. Payment was $7,500 in cash, and a $32,500 nonrecourse promissory note secured by the property and owed to Jones. The $32,500 wraparound note wraps around Jones's existing $30,000 nonrecourse note. Which of the following is true in regard to the partnership's $32,500 obligation?

    a. The $32,500 is allocated to Jones as recourse debt.

    b. None of the $32,500 is considered recourse debt, because it was nonrecourse in the first place.

    c. $2,500 is true nonrecourse debt and $30,000 is allocated entirely to Jones as recourse debt.

    d. $30,000 is true nonrecourse debt and $2,500 is allocated entirely to Jones as recourse debt.

27. How are recourse liabilities normally allocated between general and limited partners?

    a. Recourse liabilities are allocated evenly between all partners, both general and limited, in the same ratio as earnings are allocated.

    b. Recourse liabilities are allocated among general partners in the same proportion as they share losses. Limited partners do not share basis in recourse liabilities.

    c. Recourse liabilities are allocated among limited partners in the same proportion as they share losses. General partners do not share basis in recourse liabilities.

    d. Recourse liabilities are allocated entirely to the affiliated partner who arranged the debt.

28. Who is assumed to have ability to pay all of a limited partnership's liabilities?

    a. All partners are assumed liable for their share of liabilities, in the ratio of their loss-sharing agreement.

    b. All limited partners are assumed liable for the liabilities, regardless of the loss-sharing ratio.

    c. The partner who arranged for the liability is the only one liable for the debt.

    d. The general partner is assumed to have the ability to pay all of the partnership liabilities.

29. Which of the following is a circumstance under which a no-value liquidation is hypothecated?

    a. All partnership assets are assumed to be worthless.

    b. All partnership liabilities are assumed to be capable of settlement at 50% of fair value.

    c. The partnership disposes of assets in a nontaxable transaction for no consideration.

    d. The partnership allocates all items of income, gain, loss, and deduction among its partners equally, then promptly liquidates.

30. An equal partnership is formed with two partners. A deficit capital account restoration provision is incorporated in the partnership agreement. Each partner contributes $20,000 cash. The partnership borrows $1,800,000 to construct a building. The loan is on a recourse basis, with interest-only payments for five years. The partnership's initial basis is $1,800,000. In the second year, the building is placed in service. The partnership has a net loss of $80,000, $60,000 of which is depreciation, and the balance out-of-pocket cash expenses. The $80,000 loss is allocated evenly to each partner. How does the partnership allocate basis from the $1,800,000 recourse liability at the end of the second year?

    a. Partner B will be allocated basis of $1,800,000, and Partner A will be allocated all the losses from operations.

    b. Each partner has a negative capital account, so they are allocated none.

    c. Partner A will be allocated basis of $1,800,000, and Partner B will be allocated all the losses from operations.

    d. Each partner is allocated $870,000 basis net of depreciation from the $1,800,000 debt.

31. When the value of a partner's net payment obligation is adjusted because the partner is no longer required to satisfy an obligation within a reasonable period of time after the liability becomes due and payable, which of the following is true?

    a. The partner will have an unlimited amount of time in which to pay the liability.

    b. The partner can discount the liability and have no impact on the liquidation value of the liability.

    c. State laws require that the liability be absorbed by all other partners, regardless of repayment status.

    d. A partner's payment obligation also includes the amount of money or other property owned by the partner and pledged to secure the debt.

32. Which of the following occurs in a true nonrecourse liability?

    a. Partners share risk of economic loss equally.

    b. Partners share basis in risk in accordance with their loss-sharing ratio.

    c. No partner bears risk of economic loss.

    d. Nothing is booked, because no loss has been realized yet.

33. Partner A and Partner B form a limited partnership. Partner A is the general partner and Partner B is the limited partner. The limited partner contributes $90,000 and the general partner contributes $10,000. A nonrecourse loan is obtained by the partnership for $400,000 to purchase a building for $500,000. The loan is secured by the property only. The building note provides for no principal payments for five years. The general partner must restore his deficit capital account, if any, on liquidation. The general and limited partners share all partnership items on a 10/90 basis until cumulative partnership income and gain exceed cumulative partnership loss and deductions (which is called payout). After payout, all partnership items are shared equally. The partnership agreement contains a qualified income offset provision and a minimum gain chargeback provision. In each of the first 3 years of operation, the partnership had $2,500 net operating gain and a $45,000 depreciation deduction. The partnership has no nonrecourse deductions in Year 1 or 2 because the adjusted basis of the building exceeds the balance of the nonrecourse loan securing the property. However, at the end of year 3, the partnership disposes of the building in full satisfaction of the outstanding debt. As a result, the partnership realizes a $35,000 gain ($400,000 amount realized less $365,000 adjusted tax basis). This $35,000 represents minimum gain. Therefore, the partnership has $35,000 of nonrecourse depreciation deductions to be allocated to the partners in Year 3. $3,500 of the nonrecourse depreciation deduction is allocated to Partner A, and the remaining $31,500 is allocated to Partner B. Therefore, the ending capital accounts for Partners A and B are ($2,750) and ($24,750), respectively. At the end of Year 3, the partnership nonrecourse liability is allocated to the partners first pursuant to their shares of the minimum gain, with any excess allocated pursuant to the partners' shares of partnership profits. The partners share the after payout profits equally. What are the partners' respective shares of the nonrecourse debt?

   a. General Partner A = $186,000, Limited Partner B= $214,000.

   b. General Partner A = $214,000, Limited Partner B= $186,000.

   c. General Partner A = $ 2,750, Limited Partner B= $ 24,750.

   d. General Partner A = $400,000, Limited Partner B= $ -0-.

34. Which of the following is true with respect to excess nonrecourse liabilities?

   a. The partnership may first allocate an excess nonrecourse liability to the extent of a partner's built-in gain.

   b. They are never allocated among the partners.

   c. There are four allocation methods that a partnership can choose.

   d. Excess nonrecourse liabilities and all other nonrecourse liabilities are allocated under different methods and have different regulations governing them.

35. A 50/50 partnership is formed. Partner A contributes depreciable property with a tax basis of $20,000 and FMV of $50,000. The property has a $30,000 nonrecourse liability associated with it. Partner B contributes $20,000 cash. The agreement calls for 50/50 split of all partnership items of income, gain, deduction and loss. Capital accounts are kept in accordance with Sec. 704(b) safe harbor rules. So, how is the $30,000 basis from the nonrecourse liability allocated to the partners under the three-tier Sec. 752 allocation process, assuming use of the remedial method?

   a. Partner A = $0, Partner B=$20,000.

   b. Partner A= $20,000, Partner B = $0.

   c. Partner A= $0, Partner B = $0.

   d. Partner A= $0, Partner B= $10,000.

36. Which of the following statements accurately describes how partnerships are affected by guarantees and similar arrangements?

    a. Only literal guarantees are considered guarantees for Section 752 purposes.

    b. The *de minimis* rule applies to guarantees of both nonrecourse debt interest and principal.

    c. Guaranteeing partnership debt allows lenders an easier way to correct in the event of a default.

    d. Do not select this answer choice.

37. What is a consequence of converting an existing general partnership to a limited partnership, or vice versa?

    a. There are no consequences. It is simply a change of a title.

    b. The IRS imposes significant penalties for making radical entity changes such as this.

    c. It is a termination of the partnership, for income tax purposes.

    d. Such changes usually cause shifts in liability sharing because of differences in treatment between general and limited partnerships.

38. If a partner receives a liquidating distribution after that partner's Reg. 1.752-7 liability is assumed by the partnership, what is the effect on the partnership?

    a. The partnership records a deduction or capital expense for the economic performance of the Reg. 1.752-7 liability to the extent of any remaining built-in loss from the liability.

    b. There is no effect on the partnership; the partner's account is the only account affected.

    c. The partnership cannot record a deduction or capital expense as a result of economic performance of the Reg. 1.752-7 liability.

    d. The basis or capital accounts of remaining partners is decreased by the remaining built-in loss associated with the Reg. 1.752-7 liability.

Lesson 2: When FMV and Basis of Contributed Property Differ—Section 704(c) Allocations

Introduction

IRC Sec. 704(c) was drafted to prevent perceived abuses and inequities in allocating gain, loss, and deductions with respect to appreciated or depreciated property contributed by partners to partnerships. The Section 704(c) provisions come into play whenever there is a difference between the tax basis and the fair market value (FMV) of contributed property. The most common application of the Section 704(c) rules is the allocation of precontribution gain or loss to the contributing partner when the property is ultimately sold by the partnership. There are other more subtle applications of IRC Sec. 704(c), which are also covered in this lesson.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the permissible Section 704(c) allocation methods.
- Describe how to allocate gain/loss on dispositions of partnership property.
- Determine how to allocate depreciation and gains/losses under IRC Sec. 704(c) and the ceiling rule and reverse Section 704(c) allocation.

The Reasoning behind IRC Sec. 704(c)

In the early '80s, aggressive tax-saving schemes ran rampant. Congress became concerned that taxpayers owning appreciated property could reap most of the economic benefits of a sale while deferring taxable gains indefinitely by contributing appreciated property to partnerships. The following is an example of the sort of transaction Congress was worried about.

Example 2A-1 Prevention of abusive gain allocation after contribution of appreciated property to a partnership.

Generous Dynamics (a C corporation in the 35% federal tax bracket) owns appreciated real estate it wants to sell to diversify its investments. Oriental Petroleum owns several undeveloped oil and gas leases with excellent potential but has no cash to drill the wells.

Generous and Oriental decide to form GO, a 50/50 general partnership. Generous contributes its real estate, and Oriental contributes oil and gas leases of equal value. GO immediately sells the real estate for a $1 million taxable gain then uses the cash to drill and equip wells on the oil and gas leases.

The partnership agreement specifies that the taxable gain from the real estate sale is allocated 100% to Oriental Petroleum—which has an enormous NOL. The tax gain is credited to Oriental's tax-basis capital account. Generous Dynamics is allocated all intangible drilling cost (IDC) deductions, which are deducted from its tax-basis capital account. All other taxable income and gain is then allocated to Generous, and all losses to Oriental, until the partners' tax-basis capital accounts are equalized. After that point, all partnership taxable income, gain, loss, and deduction (including simulated taxable gain or loss upon a deemed sale for FMV of all partnership assets if GO is dissolved) will be allocated 50/50. The partnership agreement's liquidation provisions call for liquidation in accordance with positive tax-basis capital accounts (as adjusted for any deemed sale of assets), and there is a deficit capital account restoration provision for both partners.

This tax allocation scheme is perfectly justifiable under IRC Sec. 704(b), because it would be in accordance with the partners' interests in the partnership (PIP) standard (see Lesson 1).

Under these circumstances, Generous Dynamics could, in effect, sell its appreciated real estate and achieve its diversification goals without any current taxable gain recognition. However, IRC Sec. 704(c) prevents an allocation of precontribution gain to any partner other than the contributing partner.

> IRC Sec. 704(c) was designed to prevent *abusive* tax allocation schemes by requiring precontribution gain or loss to be allocated to the partner that contributed the property. Thus, in this example, IRC Sec. 704(c) requires that the entire $1 million taxable gain from the real estate sale be allocated to the contributing partner—Generous Dynamics.

Under IRC Sec. 704(c), differences between precontribution FMV and tax basis are also considered in allocating tax depreciation, depletion, and amortization (DD&A) with respect to contributed property. The noncontributing partners are allocated DD&A (to the extent possible) as if the property's tax basis were equal to FMV, and any remaining tax DD&A is allocated to the contributing partner. Over time, this special allocation of DD&A causes the book (FMV) and tax basis difference to diminish and eventually disappear.

Reporting Requirements

Special allocations of ordinary income or loss or DD&A under the Section 704(c) rules should not be reported as separate line items on Schedules K and K-1. Rather, the amounts allocated to each partner should be included in the amount of ordinary income or loss reported on the appropriate lines of Schedules K and K-1.

However, an additional Schedule K-1 reporting requirement applies to property distributions that fall under the Section 704(c)(1)(B) rules. If a partnership distributes any contributed property with built-in gain or loss to a partner other than the contributing partner within seven years of the contribution date, the contributing partner must recognize any of the remaining built-in gain or loss under IRC Sec. 704(c)(1)(B). If such a distribution is made, Code W should be entered on line 20 of the contributing partner's Schedule K-1, and a statement should be attached to that partner's Schedule K-1 the statement should disclose the amount of built-in gain or loss that was triggered by the Section 704(c)(1)(B) rules and identify the character of the gain or loss. The partner should in turn report this built-in gain or loss on Schedule D or Form 4797 based on the information provided by the partnership.

In addition, Schedule K-1 now includes Item M, which requires checking a box and attaching a statement if the partner contributed property with a built-in gain or loss to the partnership. For each such contribution, the required statement should show the contribution date and amount of the built-in gain or loss. If more than 10 properties are contributed on the same date, the statement can show the total number of properties contributed, the total built-in gain amount, and the total built-in loss amount. The contribution of properties with built-in gains or losses will trigger the Section 704(c) rules explained in this chapter. Such contributions can also trigger the Section 737 rules.

Effective Date Rules

The Section 704(c) principles summarized above generally apply to allocations related to property contributed to partnerships after 3/31/84. The Section 704(c) regulations (Reg. 1.704-3) apply to allocations related to property contributed on or after 12/21/93.

For property contributed before 12/21/93, taxpayers are directed to follow general tax principles in applying IRC Sec. 704(c) to transactions. Certainly, taxpayers are free to use methods consistent with the final regulations for allocations related to such contributed property.

A transition rule applies to allocations made using the remedial allocation method and to allocations made with respect to securities and similar investments. Per the preamble to Reg. 1.704-3, taxpayers can rely on the rules in former Temp. Reg. 1.704-3T for property contributed on or after 12/21/93 and before 12/28/94.

How to Apply the Section 704(c) Ceiling Rule

The ceiling rule is an important limitation on a partnership's ability to allocate income, gain, loss, and deduction among the partners for IRC Sec. 704(c) or any other purposes. The ceiling rule provides that the amount of income, gain, loss, and deduction that can be allocated to a partner for tax purposes cannot exceed 100% of each such item that the partnership actually recognizes for tax purposes. Because of the ceiling rule, a partner cannot always be allocated tax items equal to the corresponding economic profit or loss realized by that partner.

Example 2B-1 Applying the ceiling rule to a sale of property.

Ben and Barney form a partnership with Ben contributing $1,000 and Barney contributing land with a $1,000 FMV and a $600 tax basis. Ben and Barney have equal economic interests in partnership profits and losses. Both partners have a $1,000 book capital account after the contributions are made. If the land decreases in value to $900 and the partnership sells it for that price, there is a $100 economic loss, but a $300 tax gain. The economic loss is allocated $50 to each partner, reducing their book capital accounts to $950 each. It may appear that the proper way to allocate tax items is to allocate Ben a $350 gain and Barney a $50 loss. This allocation gives each partner an ending tax basis of $950, matching his ending book capital account. However, the ceiling rule limits the total allocation of tax gain to $300—the total tax gain recognized by the partnership. The entire $300 tax gain is allocated to Barney. Barney's ending tax basis is $900, and Ben's ending tax basis is $1,000. If the partnership liquidates, Barney recognizes a $50 gain and Ben a $50 loss.

Permissible Section 704(c) Allocation Methods

IRC Sec. 704(c) makes book/tax reconciliation mandatory for contributed property. The regulations provide that when a partner contributes property with a FMV different from the contributing partner's basis, the partnership can use any reasonable method to make allocations so long as the contributing partner receives the tax burdens and benefits of the precontribution gain or loss. Partnerships can use one of the three specific methods described in the regulations under IRC Sec. 704(c), or any other reasonable method. The three methods discussed in the regulations are (1) the traditional method, (2) the traditional method with curative allocations, and (3) the remedial allocation method, and are explained later in this lesson.

A partnership can use different allocation methods for different items of Section 704(c) property. However, the allocation method that is chosen must be reasonable and must be consistently applied by both the partnership and the partners from year to year. Reg. 1.704-3(a)(2) provides that it may be unreasonable to use one method for appreciated property and another for depreciated property. Similarly, it may be unreasonable to use the traditional method for built-in gain property contributed by a partner in a high tax bracket while using curative allocations for built-in gain property contributed by a partner in a low tax bracket.

Anti-abuse Rule

An allocation method will not be considered reasonable if the contribution and subsequent allocations with respect to the contributed property are made with the intent to inappropriately shift the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liabilities.

The regulations were amended in 2010 to expand the "anti-abuse" language in Reg. 1.704-3(a)(1) and (a)(10) to provide that the tax liabilities of partners and *certain direct and indirect owners of partners* are taken into account in determining if a partnership's Section 704(c) allocations are "reasonable" or "abusive." Pursuant to the amended regulations, the IRS can examine the effect of a partnership's Section 704(c) allocation method on the present value of: (1) the tax liabilities of partners *and* (2) the tax liabilities of certain direct or indirect owners of partners.

If a property contribution and subsequent Section 704(c) allocations are made with a view to shifting the tax consequences of the property's built-in gain or loss in a manner that substantially reduces the aggregate present value of such tax liabilities, the IRS can claim the allocations are "unreasonable" because they cause tax results that are inconsistent with the intent of Subchapter K (the partnership provisions of the Tax Code). The IRS can then challenge the Section 704(c) allocation method or even attempt to recast the property contribution transaction. For instance, the IRS could claim that a purported property contribution in connection with a purported partnership formation should simply be ignored with the property being treated as if there was no change in its ownership. The proposed amendments to the Section 704(c) anti-abuse rules are effective for partnership tax years beginning after 6/9/10.

Exception for Small Disparities

A partnership is not required to apply the Section 704(c) rules to a partner's contributions in a single year if both of the following criteria are met:

1. The difference between the aggregate FMV and basis of all the properties contributed by the partner during the year is 15% or less of the properties' basis.

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

Alternatively, in the case of a contribution qualifying for this small disparity rule, the partnership can choose to allocate gain or loss under IRC Sec. 704(c) only upon the disposition of property [as opposed to not applying the Section 704(c) rules at all].

Example 2C-1 Exception for small disparities between FMV and basis.

Claude enters the ABC Partnership by contributing equipment with a $219,000 FMV and a $200,000 basis. This is the only contribution he made during the year. The contribution qualifies for the small disparity rule because the disparity between FMV and basis ($19,000) is less than 15% of the basis of all the property contributed by Claude during the year ($200,000) *and* the total disparity ($19,000) is less than $20,000.

Accordingly, ABC has three choices for making allocations of tax items related to the equipment contributed by Claude. First, the partnership can simply ignore the Section 704(c) rules. Second, the partnership can ignore the Section 704(c) rules when making allocations of depreciation deductions from the equipment but allocate the precontribution gain to Claude when it is eventually sold. Third, the partnership can choose to ignore the small disparity exception and fully apply the Section 704(c) rules.

If a partnership disposes of Section 704(c) property in a nonrecognition transaction (for example, a like-kind exchange), any substituted basis property received is treated as Section 704(c) property. The property received is deemed to have the same amount of built-in gain or loss as the Section 704(c) property transferred and the partnership must continue to use the same allocation method with respect to that property.

The Traditional Method

The traditional method for complying with IRC Sec. 704(c) is described in Reg. 1.704-3(b) and requires the partnership to allocate gain or loss upon the disposition of contributed property to ensure the contributing partner is allocated any precontribution gain or loss. These rules also provide that any cost recovery deductions (depreciation, depletion, or amortization) with respect to contributed property must be allocated in the manner that most rapidly reduces the property's built-in gain or loss. This is usually accomplished by allocating book depreciation based on the partners' economic agreement (book depreciation in this case is computed using the property's FMV) and then allocating tax depreciation to the noncontributing partners up to the amount of book depreciation allocated to those partners. Any remaining tax deductions are allocated to the contributing partner or shared among the partners. The ceiling rule discussed previously applies to such allocations.

Example 2C-2 Using the traditional method when depreciated property is contributed.

Keith and Sally form K-Sal Partners to build a commercial office building on land Sally owns. Keith and Sally are equal partners. Keith contributes $200,000, and Sally contributes land with a $200,000 FMV and a $250,000 tax basis. K-Sal borrows $800,000 and completes the building using the loan proceeds and Keith's $200,000 contribution. Thus, the property's tax basis is $1,250,000, and the book basis is $1,200,000. Immediately upon completion, K-Sal sells the property for $1.5 million.

The book and tax gain on sale is allocated as follows:

	Keith		Sally		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Capital contribution	$ 200,000	$ 200,000	$ 200,000	$ 250,000	$ 400,000	$ 450,000
Book gain on sale	150,000	—	150,000	—	300,000	—
Tax gain on sale	—	150,000	—	100,000	—	250,000
Ending capital	$ 350,000	$ 350,000	$ 350,000	$ 350,000	$ 700,000	$ 700,000

The $300,000 book gain is allocated equally between Keith and Sally. Keith, the noncontributing partner, is then allocated tax gain ($150,000) equal to his book gain. The remaining tax gain ($100,000) is allocated to Sally. Sally's $50,000 of basis in excess of the property's FMV on the contribution date effectively reduces the taxable gain she recognizes when the property is sold. Note that any other allocation would produce disparities between ending book and tax-basis capital accounts.

The Traditional Method with Curative Allocations

The traditional method with curative allocations allows partners to overcome the distortions caused by the ceiling rule by making curative allocations of other partnership income or expense items. Curative allocations are tax allocations only and do not result in any related economic allocations. In other words, book capital accounts are unaffected. A curative allocation is reasonable only to the extent it does not exceed the amount necessary to offset the effect of the ceiling rule for the current tax year or, in the case of a curative allocation upon disposition of the property, for prior tax years. Additionally, a curative allocation is reasonable if the items allocated have the same tax effect on the partners as the items affected by the ceiling rule.

Example 2C-3 Using curative allocations.

Steve and Sydney form SS Partners (SSP), a general partnership. They share partnership income and loss equally. Steve contributes $100,000 and Sydney contributes equipment with a $40,000 adjusted tax basis and a $100,000 FMV. Sydney has been depreciating the equipment over 10 years using the straight-line method ($8,000 per year), and the equipment has a remaining recovery period of five years on the contribution date. Thus, the annual book depreciation will be $20,000 ($100,000 book basis depreciated over five years). SSP projects annual gross sales of $10,000 and expenses other than depreciation of $10,000. The partnership agreement provides for maintenance of capital accounts and allocation of income and loss according to the Section 704(b) safe harbor rules.

Under the traditional method with curative allocations, SSP can make curative allocations of gross income to Sydney or of other expenses to Steve. The curative allocation equals the difference between Steve's allocation of book and tax depreciation—$2,000 per year (see the table below). Assume the partners agree to make curative allocations of gross income to Sydney. Further, assume that SSP sells the equipment for $60,000 (book value) at the beginning of Year 3 (for simplicity assume no depreciation is allowed for the year of sale). The partners' FMV and tax-basis capital accounts over SSP's life are as follows:

	Steve		Sydney		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 1						
Contribution	$ 100,000	$ 100,000	$ 100,000	$ 40,000	$ 200,000	$ 140,000
Depreciation	(10,000)	(8,000)	(10,000)	—	(20,000)	(8,000)
Other expenses	(5,000)	(5,000)	(5,000)	(5,000)	(10,000)	(10,000)
Allocation of income	5,000	3,000	5,000	7,000	10,000	10,000
Year 1 ending capital	90,000	90,000	90,000	42,000	180,000	132,000

	Steve		Sydney		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 2						
Depreciation	(10,000)	(8,000)	(10,000)	—	(20,000)	(8,000)
Other expenses	(5,000)	(5,000)	(5,000)	(5,000)	(10,000)	(10,000)
Allocation of income	5,000	3,000	5,000	7,000	10,000	10,000
Year 2 ending capital	80,000	80,000	80,000	44,000	160,000	124,000
Year 3						
Allocation of book gain	—	—	—	—	—	—
Special allocation of tax gain[a]	—	—	—	36,000	—	36,000
Capital after sale	$ 80,000	$ 80,000	$ 80,000	$ 80,000	$ 160,000	$ 160,000

Note:

[a] The partnership has no book gain, but recognizes a $36,000 tax gain ($60,000 sales price – $24,000 adjusted tax basis).

Because the Year 1 allocation of tax depreciation is limited by the ceiling rule, only $8,000 of tax depreciation can be allocated to Steve. This is $2,000 less than his allocation of book depreciation. Under the traditional method with curative allocations, the $2,000 distortion in the partners' capital accounts caused by the ceiling rule can be *cured* with a tax (not book) allocation of other partnership income or expense. In this example, the partnership chooses to make a curative allocation of gross income. Under the curative allocation, Sydney is allocated $2,000 more of annual gross income than her 50% share, with Steve receiving an allocation of $2,000 less than his 50% share.

As discussed earlier, the real intent of the Section 704(c) rules is to cause differences between book and tax-basis capital accounts to vanish. In this case, the $60,000 difference between Sydney's beginning book and tax-basis capital accounts disappears via the following allocations to Sydney:

Year 1 excess of book over tax depreciation	$ 10,000
Year 1 curative tax allocation of income	2,000
Year 2 same as previous two allocations	12,000
Year 3 allocation of tax gain in excess of book gain	36,000
Total book/tax difference cured with Section 704(c) allocations	$ 60,000

The Remedial Allocation Method

Under the remedial allocation method, the partnership can, in certain situations, make tax allocations to noncontributing partners of income or gain "created out of thin air by the partnership" with offsetting allocations to the contributing partner of loss or deduction "created out of thin air by the partnership" [Reg. 1.704-3(d)]. These remedial allocations are allowed only when there is a book allocation to a noncontributing partner that is different from the tax allocation to that partner. Remedial allocations are *tax allocations only* and do not affect book capital accounts.

As with other types of Section 704(c) allocations, a remedial allocation is reasonable only to the extent it equals the amount necessary to offset the effect of the ceiling rule for the current tax year, and only if the income or loss allocated has the same effect on each partner's tax liability as the item limited by the ceiling rule. (For example, if the item limited by the ceiling rule is capital loss from the sale of contributed property, the offsetting remedial allocation to the contributing partner must be capital gain from the sale of that property.)

Depreciation Calculations under the Remedial Allocation Method

The allocation of cost recovery deductions under the remedial allocation method is different from the other two permissible methods. The remedial allocation rules require the partnership to depreciate the portion of the contributed property's book basis equal to its tax basis on the contribution date over the remaining recovery period using the same method the contributing partner used. The remainder of the partnership's book basis in the property is recovered using any recovery period and method allowed on the contribution date for newly purchased property.

Example 2C-4 Using the remedial allocation method.

Assume the same facts as in Example 2C-3, except SSP decides to use the remedial allocation method to make Section 704(c) allocations. Book (FMV) depreciation is computed by depreciating property with a $40,000 tax basis (the carryover basis from Sydney) using the remaining recovery period and depreciation method Sydney used (five years, straight-line), and treating the additional $60,000 of basis as new property (10 years, straight-line). Allocations to Steve and Sydney during Year 1 would be:

	Steve		Sydney		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 1						
Contribution	$ 100,000	$ 100,000	$ 100,000	$ 40,000	$ 200,000	$ 140,000
Depreciation	(7,000)	(7,000)	(7,000)	(1,000)	(14,000)	(8,000)
Year 1 ending capital	$ 93,000	$ 93,000	$ 93,000	$ 39,000	$ 186,000	$ 132,000

No remedial allocation is allowed since Steve's book and tax allocations are the same. This continues for Years 2 through 5—since there is enough tax depreciation in those years to match Steve's book depreciation allocations. At the end of Year 5, Steve and Sydney have the following capital account balances:

	Steve		Sydney		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 1 ending capital	$ 93,000	$ 93,000	$ 93,000	$ 39,000	$ 186,000	$ 132,000
Years 2–5 depreciation	(28,000)	(28,000)	(28,000)	(4,000)	(56,000)	(32,000)
Year 5 ending capital	$ 65,000	$ 65,000	$ 65,000	$ 35,000	$ 130,000	$ 100,000

Beginning in Year 6, the contributed property is not generating any tax depreciation expense, creating a situation in which Steve's allocated book depreciation is not matched by an equal amount of tax depreciation. Therefore, the partnership must make remedial allocations to Steve and Sydney for Year 6 as follows:

	Steve		Sydney		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 5 ending capital	$ 65,000	$ 65,000	$ 65,000	$ 35,000	$ 130,000	$ 100,000
Depreciation	(3,000)	—	(3,000)	—	(6,000)	—
Remedial allocation	—	(3,000)	—	3,000	—	—
Year 6 ending capital	$ 62,000	$ 62,000	$ 62,000	$ 38,000	$ 124,000	$ 100,000

The partnership makes a $3,000 remedial allocation of tax depreciation expense to Steve (the noncontributing partner). After the remedial allocation, Steve's book and tax allocations are the same. The partnership must then make an offsetting remedial $3,000 allocation of ordinary income to Sydney. This allocation is made even if the partnership did not recognize $3,000 of ordinary income in the current year.

If the property is sold at the beginning of Year 7 for $20,000, the partnership recognizes a $4,000 book loss and a $20,000 tax gain. The allocation of this gain between the partners is as follows:

	Steve		Sydney		Partnership	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 6 ending capital	$ 62,000	$ 62,000	$ 62,000	$ 38,000	$ 124,000	$ 100,000
Gain (loss) on sale	(2,000)	—	(2,000)	20,000	(4,000)	20,000
Remedial allocation	—	(2,000)	—	2,000	—	—
Ending capital	$ 60,000	$ 60,000	$ 60,000	$ 60,000	$ 120,000	$ 120,000

Since the remedial allocation to Steve is a capital loss on the sale, the remedial allocation to Sydney must be a capital gain on the sale.

See Examples 2F-3, 2F-4, and 2F-5 for additional examples of the traditional allocation method, traditional with curative allocation method, and the remedial allocation method, respectively. These examples involve partnerships that are not 50/50 deals.

Example 2C-5 Unreasonable Section 704(c) allocation method.

Assume the same facts as in Example 2C-4, except SSP declines to use any of the three Section 704(c) allocation methods specified in the regulations. Instead the partnership decides to use its own allocation method, which involves immediate equalization of the tax basis capital accounts of the two partners. Effective on Day 1 of Year 1, Sydney (who has a large expiring NOL) is allocated $30,000 of phantom partnership taxable income and Steve (who is in the 35% tax bracket) is allocated $30,000 of offsetting phantom partnership taxable loss. Thus after Day 1, each partner has a tax-basis capital account of $70,000. (The tax allocations of phantom income and loss have no effect on the partners' book capital accounts, which are $100,000 each.) The partnership will then allocate all book and tax items 50/50, including the tax depreciation from the appreciated property contributed by Sydney.

This approach is somewhat similar to the remedial allocation method explained earlier in this lesson, except it immediately equalizes the two partners' tax basis capital accounts. This immediate remedial allocation scheme does address the difference between the FMV and basis of contributed property, but it probably would be deemed *unreasonable* by the IRS. It appears the IRS views *reasonable* Section 704(c) allocation methods as those that gradually reduce the differences between FMV and basis as contributed property is depreciated, amortized, or sold by the partnership.

Also, because the Section 704(c) allocation method used in this example appears to be coordinated with the individual tax planning needs of Sydney and Steve, it would probably run afoul of the anti-abuse rule in the Section 704(c) regulations. Finally, Reg. 1.704-3(a)(1) indicates that methods creating tax allocations that are independent from allocations affecting book capital accounts (such as the method used in this example) are generally not reasonable unless they are supported by published guidance.

Aggregation of Contributed Property

Contributed property generally cannot be aggregated for purposes of applying the Section 704(c) rules. In other words, gains inherent in appreciated contributed property cannot be offset with losses inherent in depreciated contributed property in order to conclude that there is no tax basis/FMV differential to worry about. However, each of the following types of property *can* be aggregated if contributed by one partner during the partnership's tax year.

1. Depreciable property that is not real property and that is included in the same general asset account of the contributing partner and partnership under IRC Sec. 168.

2. Property with a zero basis that is not real property (such as unrealized receivables).

3. Inventory if the partnership does not use the specific identification method of accounting for tracking inventory.

In addition to these situations specified in the regulations, the IRS can allow partnerships to aggregate their Section 704(c) property whenever the IRS deems this to be acceptable. For example, in Ltr. Rul. 9608011 the IRS allowed aggregation of Section 704(c) gains with respect to appreciated timber properties contributed by three partnerships to a Master Partnership (in which the three *upper level* partnerships were the partners). The total built-in gain recognized when the Master Partnership sold any specific lot of timber was then simply allocated to each upper-level partnership in proportion to that partnership's share of the aggregate Master Partnership built-in gain from all contributed timber properties.

Tiered Partnerships

When an upper-tier partnership contributes Section 704(c) property to a lower-tier partnership, the upper-tier partnership must allocate its distributive share of lower-tier partnership income and expense among upper-tier partners in a manner that considers the contributing partner's remaining built-in gain or loss.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Two companies form a 50/50 general partnership. One company contributes real estate and the other contributes oil and gas leases of equal value. The partnership sells the real estate for a $500,000 gain to purchase drilling equipment for use on the oil and gas leases. The partnership agreement gives taxable gain from the real estate sale to the company contributing the oil and gas leases, which has a large NOL. The company contributing the real estate is allocated all intangible drilling cost deductions, and all other taxable income and gain is allocated to it until both partners' tax-basis capital accounts are equalized. After that point, all taxable income, gain, loss, and deduction will be allocated 50/50. The agreement calls for liquidation in accordance with positive tax-basis capital account, and contains a deficit capital account restoration provision for both parties. This tax allocation scheme is—

    a. not justifiable under Sec. 704(b).

    b. an example of the kind of tax allocation IRC Sec. 704(c) was designed to promote.

    c. a situation in which allocation of tax depreciation, depletion, and amortization related to the contributed property would be 100% to the contributing partner.

    d. not in accordance with Sec. 704(c), which requires allocation of all taxable gain from the real estate sale to the contributing partner.

36. What will result in a determination that a Sec. 704(c) allocation method is **not** reasonable?

    a. Allocation made with intent to shift tax consequences of built-in gain/loss.

    b. Use of different allocation methods for different items of Section 704(c) property.

    c. Allocating tax burden and benefits of precontribution gain/loss to the contributing partner.

    d. Failure to use one method for appreciated property and another method for depreciated property.

37. A general partnership is formed in which the partners share income and loss equally. Partner A contributes $100,000 and Partner B contributes equipment with FMV $100,000 and adjusted tax basis $40,000. The equipment had been depreciated over a 10 year period using straight line depreciation ($8,000 per year) and 5 years remain on the recovery period, so annual book depreciation is $20,000. Annual gross sales of $10,000 are projected and total cash expenses are projected at $10,000. The partnership agreement requires maintenance of capital accounts and allocation of income and loss using Sec. 704(b) safe harbor rules. What is Partner B's capital account (tax basis) at the end of year 1, using the traditional method with curative allocations (assume partners agree to make curative allocations to Partner B)?

    a. $180,000.

    b. $90,000.

    c. $44,000.

    d. $42,000.

38. A general partnership is formed in which the partners share income and loss equally. Partner A contributes $5,000 and Partner B contributes equipment with FMV $5,000 and adjusted tax basis $2,000. The equipment had been depreciated over a 10 year period using straight line depreciation ($400 per year) and 5 years remain on the recovery period, so annual book depreciation is $1,000. Annual gross sales of $500 are projected and total cash expenses are projected at $500. The partnership agreement requires maintenance of capital accounts and allocation of income and loss using Sec 704(b) safe harbor rules. What is Partner A's capital account (tax basis) at the end of year 1, using the traditional method with curative allocations (assume partners agree to make curative allocations to Partner B)?

   a. $2,000.

   b. $3,900.

   c. $4,500.

   d. $5,000.

39. Explain depreciation calculations under the remedial allocation method.

   a. Cost recovery deductions, such as depreciation, must be allocated in the way that will reduce built-in gain or loss the most rapidly.

   b. The remedial allocation method does not provide for depreciation, therefore, the method does not require depreciation. If it did, however, it would probably look like one of the common methods.

   c. The partnership depreciates the portion of contributed property's book basis equal to tax basis on the contribution date over the remaining recovery period using the contributing partner's method.

40. What condition must be satisfied for contribution of Section 704(c) property from an upper-tier partnership to a lower-tier partnership?

   a. Distributive share allocation of upper-tier partnership income and expense among lower-tier partners in consideration of the contributing partner's remaining built-in gain or loss.

   b. Distributive share allocation of lower-tier partnership income and expense among upper-tier partners in consideration of the contributing partner's remaining built-in gain or loss.

   c. Distributive share allocation of upper-tier partnership income and expense among upper-tier partners in consideration of the contributing partner's remaining built-in gain or loss.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Two companies form a 50/50 general partnership. One company contributes real estate and the other contributes oil and gas leases of equal value. The partnership sells the real estate for a $500,000 gain to purchase drilling equipment for use on the oil and gas leases. The partnership agreement gives taxable gain from the real estate sale to the company contributing the oil and gas leases, which has a large NOL. The company contributing the real estate is allocated all intangible drilling cost deductions, and all other taxable income and gain is allocated to it until both partners' tax-basis capital accounts are equalized. After that point, all taxable income, gain, loss, and deduction will be allocated 50/50. The agreement calls for liquidation in accordance with positive tax-basis capital account, and contains a deficit capital account restoration provision for both parties. This tax allocation scheme is— **(Page 81)**

    a. not justifiable under Sec. 704(b). [This answer is incorrect. It would be in accordance with the partners' interests in the partnership standard.]

    b. an example of the kind of tax allocation IRC Sec. 704(c) was designed to promote. [This answer is incorrect. This is an example of what IRC Sec. 704 (c) was designed to prevent.]

    c. a situation in which allocation of tax depreciation, depletion, and amortization related to the contributed property would be 100% to the contributing partner. [This answer is incorrect. DD&A is allocated to the extent possible to noncontributing partners.]

    d. not in accordance with Sec. 704(c), which requires allocation of all taxable gain from the real estate sale to the contributing partner. [This answer is correct. It would be in compliance if the gain were not allocated to the noncontributing partner.]

36. What will result in a determination that a Sec. 704(c) allocation method is **not** reasonable? **(Page 83)**

    a. Allocation made with intent to shift tax consequences of built-in gain/loss. [This answer is correct. The intent to shift tax consequences in a way to reduce present value of the aggregate tax liabilities of the partners will be considered unreasonable under Sec. 704(c) because it causes tax results that are inconsistent with the related provisions of the tax code.]

    b. Use of different allocation methods for different items of Section 704(c) property. [This answer is incorrect. Using different methods for different items is appropriate.]

    c. Allocating tax burden and benefits of precontribution gain/loss to the contributing partner. [This answer is incorrect. These items are required to be allocated to the contributing partner.]

    d. Failure to use one method for appreciated property and another method for depreciated property. [This answer is incorrect. Use of one method for appreciated and another for depreciated property may be considered unreasonable under Reg. 1.704-3(a)(2).]

37. A general partnership is formed in which the partners share income and loss equally. Partner A contributes $100,000 and Partner B contributes equipment with FMV $100,000 and adjusted tax basis $40,000. The equipment had been depreciated over a 10 year period using straight line depreciation ($8,000 per year) and 5 years remain on the recovery period, so annual book depreciation is $20,000. Annual gross sales of $10,000 are projected and total cash expenses are projected at $10,000. The partnership agreement requires maintenance of capital accounts and allocation of income and loss using Sec. 704(b) safe harbor rules. What is Partner B's capital account (tax basis) at the end of year 1, using the traditional method with curative allocations (assume partners agree to make curative allocations to Partner B)? **(Page 83)**

    a. $180,000. [This answer is incorrect. It is the partnership FMV basis at year 1.]

    b. $90,000. [This answer is incorrect. It is the FMV basis at year 1.]

    c. $44,000. [This answer is incorrect. It is the tax basis balance for Partner B at year 2.]

    d. $42,000. [This answer is correct. It is the initial tax basis contribution, share of other expenses, and allocation of income for year 1.]

38. A general partnership is formed in which the partners share income and loss equally. Partner A contributes $5,000 and Partner B contributes equipment with FMV $5,000 and adjusted tax basis $2,000. The equipment had been depreciated over a 10 year period using straight line depreciation ($400 per year) and 5 years remain on the recovery period, so annual book depreciation is $1,000. Annual gross sales of $500 are projected and total cash expenses are projected at $500. The partnership agreement requires maintenance of capital accounts and allocation of income and loss using Sec 704(b) safe harbor rules. What is Partner A's capital account (tax basis) at the end of year 1, using the traditional method with curative allocations (assume partners agree to make curative allocations to Partner B)? **(Page 83)**

    a. $2,000. [This answer is in incorrect. It is the initial tax basis contribution for Partner B.]

    b. $3,900. [This answer is correct. It is the initial tax basis contribution, share of other expenses, and allocation of income for year 1 as well as curative allocation to Partner B.]

    c. $4,500. [This answer is incorrect. It is the FMV basis at the end of year 1.]

    d. $5,000. [This answer is incorrect. It is the initial tax basis contribution for Partner A.]

39. Explain depreciation calculations under the remedial allocation method. **(Page 83)**

    a. Cost recovery deductions, such as depreciation, must be allocated in the way that will reduce built-in gain or loss the most rapidly. [This answer is incorrect. Under the traditional method, not the remedial allocation method, any cost recovery deductions (depreciation, depletion, or amortization) with respect to contributed property must be allocated in the manner that most rapidly reduces the property's built-in gain or loss.]

    b. The remedial allocation method does not provide for depreciation, therefore, the method does not require depreciation. If it did, however, it would probably look like one of the common methods. [This answer is incorrect. The IRS regulations regarding the remedial allocation method requires depreciation and amortization of capital assets.]

    c. The partnership depreciates the portion of contributed property's book basis equal to tax basis on the contribution date over the remaining recovery period using the contributing partner's method. [This answer is correct. The remainder of the partnership's book basis in the property is recovered using any recovery period and method allowed on the contribution date for newly purchased property.]

40. What condition must be satisfied for contribution of Section 704(c) property from an upper-tier partnership to a lower-tier partnership? **(Page 89)**

   a. Distributive share allocation of upper-tier partnership income and expense among lower-tier partners in consideration of the contributing partner's remaining built-in gain or loss. [This answer is incorrect. This definition has reversed the upper-tier and lower-tier relationship.]

   b. Distributive share allocation of lower-tier partnership income and expense among upper-tier partners in consideration of the contributing partner's remaining built-in gain or loss. [This answer is correct. As required by Sec. 704(c), the allocation of income/expense must be distributed in a manner that considers the contributing partner's remaining built-in gain or loss.]

   c. Distributive share allocation of upper-tier partnership income and expense among upper-tier partners in consideration of the contributing partner's remaining built-in gain or loss. [This answer is incorrect. The income and expense allocation from lower-tier partners is the issue, not the upper-tier partnership income and expense.]

How to Allocate Gain/Loss for Dispositions of Partnership Property

Background

A common misconception is that the Section 704(c) rules apply only to property with precontribution gain and only to *hard assets* such as real estate and equipment. In fact, IRC Sec. 704(c) applies to any property contributed if there is a difference between its FMV and tax basis at the time of contribution. IRC Sec. 704(c) applies to items such as precontribution loss property, unrealized receivables of a cash-basis taxpayer, and appreciated inventory. Also, IRC Sec. 704(c) applies to the *contribution* of payables and other accrued but unpaid items—under rules to be covered in regulations not yet released.

The Section 704(c) rules can be properly applied only if precontribution differences (if any) between FMV and tax basis can be estimated with reasonable precision. If such differences (or the lack thereof) are not adequately documented, the IRS can be expected to question upon audit all tax allocations related to contributed property. Accordingly, it is highly advisable for partnerships to obtain documentation (preferably in the form of written appraisals by qualified professionals) of precontribution FMV and basis amounts whenever significant contributions of property (including unrealized receivables, cash-basis payables, etc.) occur.

Examples 2D-1 through 2D-4 illustrate how to use the traditional method to make Section 704(c) allocations of gains and losses upon sales of contributed property.

Example 2D-1 Allocating precontribution gain.

Dan and Chris form a 50/50 partnership, SpecArt Joint Venture, to speculate in valuable art objects. Dan contributes a somewhat rare original painting by Alphonse, which has an agreed-upon FMV of $10,000 and a $50 tax basis. Thus, there is a $9,950 precontribution tax gain with respect to the Alphonse painting. Chris contributes $10,000. Alphonse dies one week later and the market for his paintings goes crazy. SpecArt sells the painting for $25,000. The following Section 704(c) capital account analysis shows how to allocate the $24,950 taxable gain.

	Chris		Dan		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Contributions	$ 10,000	$ 10,000	$ 10,000	$ 50	$ 20,000	$ 10,050
Gain on painting	7,500	7,500	7,500	17,450	15,000	24,950
Capital	$ 17,500	$ 17,500	$ 17,500	$ 17,500	$ 35,000	$ 35,000

The entire precontribution taxable gain of $9,950 is allocated to Dan—the partner who contributed the property that was sold. The remaining tax gain ($15,000) is allocated 50/50. Any other tax allocation would increase the differences between the partners' tax-basis and FMV capital accounts. The objective of the Section 704(c) rule is to equalize tax-basis and FMV capital accounts.

Example 2D-2 Allocating precontribution loss.

John and Ann form Honest John's Joint Venture (a 50/50 partnership) to enter the used car business. John contributes a used Cadillac with an agreed-upon $15,000 FMV and $20,000 tax basis. Thus, there is a $5,000 precontribution loss with respect to the Cadillac. Ann contributes $15,000. Honest John's sells the Cadillac for $13,500. The following Section 704(c) capital account analysis shows how to allocate the $6,500 tax loss on the sale.

	Ann		John		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Contributions	$ 15,000	$ 15,000	$ 15,000	$ 20,000	$ 30,000	$ 35,000
Loss on Cadillac	(750)	(750)	(750)	(5,750)	(1,500)	(6,500)
Capital	$ 14,250	$ 14,250	$ 14,250	$ 14,250	$ 28,500	$ 28,500

The entire $5,000 precontribution taxable loss is allocated to John—the contributing partner. The remaining $1,500 of taxable loss is allocated 50/50. Any other tax allocation would increase the differences between the partners' tax-basis and FMV capital accounts.

Example 2D-3 Sale of precontribution gain property for a taxable loss—using the ceiling rule.

Richard and Cindy form Dude, Ltd., a 50/50 partnership, to produce and sell lithographs. Richard contributes $10,000, and Cindy contributes used printing equipment with a $10,000 FMV and a $6,000 tax basis. Thus, there is a $4,000 precontribution tax gain with respect to the printing equipment. Two days after the partnership is formed (after an unanticipated collapse in the market for used printing equipment), the partnership sells the printing equipment for $5,000—a tax loss of $1,000.

IRC Sec. 704(c) states allocations of loss with respect to contributed property will take into account the variation between tax basis and FMV. The implication of this language is that tax allocations with respect to contributed property are made so differences between FMV and basis are decreased. In this example, Richard must be allocated the entire $1,000 tax loss. Any other allocation of tax loss would increase (rather than decrease) the variation between tax-basis and FMV capital accounts, as the following Section 704(c) capital account analysis shows.

	Richard		Cindy		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Initial contributions	$ 10,000	$ 10,000	$ 10,000	$ 6,000	$ 20,000	$ 16,000
Loss on sale	(2,500)	(1,000)	(2,500)	—	(5,000)	(1,000)
Capital	$ 7,500	$ 9,000	$ 7,500	$ 6,000	$ 15,000	$ 15,000

In this example, the ceiling rule means that any partnership tax loss up to Richard's book loss (based on FMV) will be allocated 100% to Richard. Any remaining tax loss would be allocated 100% to Cindy. In this case, there is no tax loss left to allocate to Cindy because the partnership's tax loss ($1,000) is less than Richard's share of the book loss ($2,500).

Allocating Gain/Loss When Basis Adjustment Applies to Section 704(c) Property

A partnership basis adjustment is made with respect to a transferee partner when the partnership has a Section 754 optional basis adjustment election in effect. The basis adjustment is allocated to specific partnership assets and is applicable only to the transferee partner (other partners are completely unaffected). In essence, the basis adjustment belongs to the transferee partner.

In some cases, the asset to which a basis adjustment applies will also be subject to the Section 704(c) rules explained in this lesson, because there was a difference between adjusted basis and FMV at the time the asset was contributed to the partnership. Reg. 1.743-1(j)(3) explains how to allocate the resulting tax gain or loss when such an asset is sold by the partnership. According to the regulation, the transferee partner's gain/loss equals: (1) the transferee partner's share of partnership gain/loss under the Section 704(c) rules (including any remedial allocation); (2) minus the transferee partner's positive basis adjustment, if any; (3) plus the transferee partner's negative basis adjustment, if any. The following two examples illustrate these rules.

Example 2D-4 Traditional method used for Section 704(c) allocations.

Garth and Britney form an equal partnership to develop some raw land (a nondepreciable asset) contributed by Garth. The land's tax basis is $50,000, and it has a FMV of $100,000. Britney contributes $100,000 cash. Both partners are credited with *book* capital accounts of $100,000. The partnership uses the traditional method to make its Section 704(c) allocations.

Shortly thereafter, Garth sells his interest to Tim for $100,000 and the partnership makes a Section 754 election. Accordingly, a $50,000 positive basis adjustment is made to the land with respect to Tim (the transferee partner).

The partnership later sells the land for $90,000 after concluding that development is inadvisable at that time. In this example, there is a book loss of $10,000 ($90,000 sales proceeds − $100,000 book basis) but a tax gain of $40,000 ($90,000 − $50,000 tax basis). Tim and Britney are each allocated book losses of $5,000.

Under the Section 704(c) rules, Tim is allocated the entire $40,000 tax gain. However, the gain is offset (and then some) by the $50,000 loss attributable to his positive basis adjustment. Therefore, Tim reports a tax loss of $10,000 [$40,000 Section 704(c) gain − $50,000 loss from the basis adjustment]. After the sale, Tim's book capital account is $95,000 ($100,000 purchase price − $5,000 of book loss), while his tax basis capital account is $90,000 ($100,000 purchase price − $10,000 tax loss). After the sale, Britney's book capital account is $95,000, and her tax basis capital account is $100,000.

Example 2D-5 Remedial method used for Section 704(c) allocations.

Assume the same facts as in Example 2D-4, except the partnership uses the remedial method to make its Section 704(c) allocations. As before, both Tim and Britney have book capital accounts of $95,000 after the sale (reflecting the 50/50 split of the $10,000 book loss). As before, the Section 704(c) rules require that Tim be allocated the entire $40,000 partnership tax gain, however this is offset by the $50,000 loss attributable to his positive basis adjustment. Therefore, Tim reports a $10,000 tax loss. Tim is then given a remedial $5,000 gain allocation, while Britney is given a remedial $5,000 loss allocation.

After the sale, Tim's tax basis capital account is $95,000 ($100,000 purchase price − $10,000 tax loss + $5,000 remedial gain allocation). Britney's tax basis capital account is also $95,000 ($100,000 initial basis − $5,000 remedial loss allocation).

As can be seen, the remedial allocations equalize the partner's book and tax basis capital accounts. This was not the case in Example 2D-4, where the partnership used the traditional method to make its Section 704(c) allocations.

Contributions of Cash-basis Receivables and Liabilities

IRC Sec. 704(c) also applies to contributions of cash basis receivables and payables, not just to contributions of hard assets. However, regulations have yet to be issued that provide specific guidance or examples on the application of the Section 704(c) principles to liabilities. The following example assumes Section 704(c) principles can be applied to liability items.

Example 2D-6 Contribution of cash-basis receivables and liabilities.

Jack Jackson, D.D.S., and Martha Bergstrom, D.D.S., have been practicing general dentistry. They have had several discussions about combining their practices. Both Jack and Martha have operated their practices as sole proprietorships and reported their earnings on the cash basis for tax purposes. Jack and Martha agree the equity amounts in their practices are of equal value and propose to contribute their respective practices for equal 50% interests in capital and profits of the newly formed partnership. The two practices' tax-basis balance sheets (adjusted to include cash basis receivables and payables) on the contribution date are:

	Jackson	Bergstrom
Cash	$ 2,500	$ 1,500
Accounts receivable (not yet reported as income)	52,500	56,500
Unbilled jobs and work-in-process (not yet reported as income)	5,500	6,500
Dental equipment (assume basis and FMV are equal)	14,000	8,000
Other assets	1,500	500
Total assets	$ 76,000	$ 73,000
Accounts payable (not yet deducted)	$ 50,000	$ 48,500
Accrued expenses (not yet deducted)	7,500	5,000
Bank debt	9,500	10,500
Capital	9,000	9,000
Total liabilities and capital	$ 76,000	$ 73,000

IRC Sec. 704(c) requires that the difference between the cash-basis assets' adjusted tax bases and FMV be allocated to the contributing partners. Also, the tax deductions from the cash-basis liabilities are allocated to the contributing partners. Therefore, Jackson and Bergstrom will have the following taxable income and deductions allocated to them under IRC Sec. 704(c) principles:

	Jackson	Bergstrom
FMV of receivables and work-in-process	$ 58,000	$ 63,000
Tax basis of these assets	—	—
Taxable income to be allocated to contributing partners under IRC Sec. 704(c)	58,000	63,000
Less cash-basis expense liabilities transferred to partnership	(57,500)	(53,500)
Net partnership taxable income to be allocated back to contributing partners to comply with Sec. 704(c) rules	$ 500	$ 9,500

Assume that at the end of the partnership's initial year, all the contributed accounts receivable and work-in-process amounts have been collected, and all the contributed payables and accrued expenses have been paid. Taking these contributed amounts into account along with other partnership income and expense items recognized for the year results in $100,000 of net cash-basis income. Of that amount, $500 would be allocated back to Jackson and $9,500 would be allocated back to Bergstrom under the Section 704(c) rules. The remaining $90,000 would be allocated 50% to Jackson and 50% to Bergstrom pursuant to the partnership agreement.

Installment Sale of Contributed Property

When contributed appreciated property subject to the Section 704(c) rules is sold by the partnership in an installment sale transaction, the resulting note receivable is also subject to the Section 704(c) rules. Therefore, subsequent partnership gains recognized as the partnership collects principal payments on the note must be allocated among the partners in the same fashion as if the property had been sold for cash. In other words, arranging an installment sale will not allow the partnership to alter the allocation of gain mandated by the Section 704(c) rules.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

41. Section 704(c) applies to which of the following?

    a. Any property contributed if, at time of contribution, a difference between FMV and tax basis exists.

    b. Only to property with pre-contribution gain with a difference between FMV and tax basis in the property contributed that cannot be reasonably estimated.

    c. Only to "hard" assets (e.g., equipment, real estate, etc.).

    d. Property other than payables and other accrued but unpaid items.

42. A 50/50 partnership is formed with Partner A contributing property with FMV $30,000 and tax basis $40,000, and Partner B contributing $30,000. The partnership sells the property for $27,000. What is the tax basis account effect?

    a. $13,000 to A, $13,000 to B.

    b. $1,500 to A, $1,500 to B.

    c. $3,000 to A, $3,000 to B.

    d. $11,500 to A, $1,500 to B.

43. A 60/40 partnership is formed with Partner A (60%) contributing property with FMV $300,000 and tax basis $400,000, and Partner B (40%) contributing $300,000. The partnership sells the property for $270,000. What is the tax basis account balance for Partner B after the sale?

    a. $18,000.

    b. $282,000.

    c. $288,000.

    d. $300,000.

44. A 50/50 partnership is formed with Partner A contributing land with FMV $50,000 and tax basis $25,000, and Partner B contributing $50,000 cash. [The partnership makes Sec. 704(c) allocations using the traditional method.] Later, Partner A sells his interest to an outside party (Partner C) for $50,000, and the partnership makes a Sec. 754 election. Still later, the land is sold for $45,000. What are the remaining capital account balances after the sale results are allocated?

    a. B's tax basis account balance is $47,500 and book account is $50,000.

    b. C's tax basis account balance is $45,000 and book account is $47,500.

    c. B's tax basis account balance is $95,000 and book account is $95,000.

    d. C's tax basis account balance is $95,000 and book account is $95,000.

45. A 60/40 partnership is formed with Partner A (40%) contributing land with FMV of $40,000 and tax basis of $35,000, and Partner B contributing $40,000 cash. (The partnership makes Sec 704(c) allocations using the traditional method.) Later, Partner A sells his interest to an outside party (Partner C) for $40,000, and the partnership makes a Sec 754 election. Still later, the land is sold for $35,000. What are the remaining capital account balances after the sale results are allocated?

    a. B's tax basis account balance is $48,000 and book account is $50,000.

    b. C's tax basis account balance is $35,000 and book account is $37,000.

    c. B's tax basis account balance is $50,000 and book account is $50,000.

    d. C's tax basis account balance is $85,000 and book account is $95,000.

46. What is the effect on the partnership when a partnership sells contributed appreciated property subject to Section 704(c), and the sale is an installment sale?

    a. The note receivable related to the sale is subject to Section 704(c) rules, so subsequent gains from principal collections recognized by the partnership are allocated as if the sale had been for cash.

    b. The note receivable related to the sale is not subject to Section 704(c), which allows the partnership to engage in tax-deferred property swaps outside Section 1031, and insures the capital accounts are not affected by the installment sale.

    c. It has no unusual affect on the partnership accounts, because the sale is recognized as if it were a sale for cash, and accounts are adjusted accordingly.

    d. The note receivable related to the sale is subject to Section 704(c), but because it is an installment sale, the partnership is, in effect, allowed to alter the allocation of gain mandated by the Section 704(c) rules.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

41. Section 704(c) applies to which of the following? **(Page 96)**

    a. Any property contributed if, at time of contribution, a difference between FMV and tax basis exists. [This answer is correct. A common misconception is that Sec. 704(c) applies only to property with precontribution gain and only to hard assets. In fact, Sec. 704(c) applies to any property contributed when there is a basis difference between FMV and tax at the date of contribution.]

    b. Only to property with pre-contribution gain with a difference between FMV and tax basis in the property contributed that cannot be reasonably estimated. [This answer is incorrect. Sec. 704(c) applies to any property with pre-contribution differences between FMV and tax basis that can be estimated with reasonable precision.]

    c. Only to "hard" assets (e.g., equipment, real estate, etc.). [This answer is incorrect. Sec. 704(c) applies to any asset meeting the Sec. 704(c) requirements which include inventory and receivables.]

    d. Property other than payables and other accrued but unpaid items. [This answer is incorrect. Applicability of Sec. 704(c) includes contribution of payables and other accrued but unpaid items; however, the rules governing these types of contributions have yet to be released.]

42. A 50/50 partnership is formed with Partner A contributing property with FMV $30,000 and tax basis $40,000, and Partner B contributing $30,000. The partnership sells the property for $27,000. What is the tax basis account effect? **(Page 96)**

    a. $13,000 to A, $13,000 to B. [This answer is incorrect. This amount is the partnership's tax basis total.]

    b. $1,500 to A, $1,500 to B. [This answer is incorrect. This is the book allocation to each partner, not the tax basis allocation.]

    c. $3,000 to A, $1,500 to B. [This answer is incorrect. This is the total book account balance for the partnership, and the book account allocation for each partner.]

    d. $11,500 to A, $1,500 to B. [This answer is correct. A is allocated the built-in loss, and shares the balance with B.]

43. A 60/40 partnership is formed with Partner A (60%) contributing property with FMV $300,000 and tax basis $400,000, and Partner B (40%) contributing $300,000. The partnership sells the property for $270,000. What is the tax basis account balance for Partner B after the sale? **(Page 96)**

    a. $18,000. [This answer is incorrect. This is the book allocation to Partner A.]

    b. $282,000. [This answer is incorrect. This amount is Partner A's basis after sale.]

    c. $288,000. [This answer is correct. A is allocated the built-in loss, and shares the balance with B based on a 60/40 arrangement.]

    d. $300,000. [This answer is incorrect. This amount is Partner B's cash contributions.]

44. A 50/50 partnership is formed with Partner A contributing land with FMV $50,000 and tax basis $25,000, and Partner B contributing $50,000 cash. [The partnership makes Sec. 704(c) allocations using the traditional method.] Later, Partner A sells his interest to an outside party (Partner C) for $50,000, and the partnership makes a Sec. 754 election. Still later, the land is sold for $45,000. What are the remaining capital account balances after the sale results are allocated? **(Page 96)**

   a. B's tax basis account balance is $47,500 and book account is $50,000. [This answer is incorrect. The amounts are reversed for the tax basis and book accounts.]

   b. C's tax basis account balance is $45,000 and book account is $47,500. [This answer is correct. After considering the Sec. 754 adjustment to capital for the land, deducting the loss on sale, and adding the tax gain on the sale, these are the correct balances for C.]

   c. B's tax basis account balance is $95,000 and book account is $95,000. [This answer is incorrect. It is the total of the partnership's accounts for those categories.]

   d. C's tax basis account balance is $95,000 and book account is $95,000. [This answer is incorrect. It reflects the total of the partners' capital accounts.]

45. A 60/40 partnership is formed with Partner A (40%) contributing land with FMV $40,000 and tax basis $35,000, and Partner B (60%) contributing $40,000 cash. (The partnership makes Sec 704(c) allocations using the traditional method.) Later, Partner A sells his interest to an outside party (Partner C) for $40,000, and the partnership makes a Sec 754 election. Still later, the land is sold for $35,000. What are the remaining capital account balances after the sale results are allocated? **(Page 96)**

   a. B's tax basis account balance is $48,000 and book account is $50,000. [This answer is incorrect. The amounts are reversed for the tax basis and book accounts.]

   b. C's tax basis account balance is $35,000 and book account is $37,000. [This answer is correct. After considering the Sec 754 adjustment to capital for the land, deducting the loss on sale, and adding the tax gain on the sale, these are the correct balances for C.]

   c. B's tax basis account balance is $50,000 and book account is $50,000. [This answer is incorrect. It is the initial capital for B.]

   d. C's tax basis account balance is $85,000 and book account is $95,000. [This answer is incorrect. It reflects the total of the partners' capital accounts.]

46. What is the effect on the partnership when a partnership sells contributed appreciated property subject to Section 704(c), and the sale is an installment sale? **(Page 105)**

   a. The note receivable related to the sale is subject to Section 704(c) rules, so subsequent gains from principal collections recognized by the partnership are allocated as if the sale had been for cash. [This answer is correct. Installment sale of Section 704(c) property will not allow the partnership to alter the allocation of gains mandated by Section 704(c).]

   b. The note receivable related to the sale is not subject to Section 704(c), which allows the partnership to engage in tax-deferred property swaps outside Section 1031; and insures the capital accounts are not affected by the installment sale. [This answer is incorrect. The note receivable resulting from an installment sale of Section 704(c) property is subject to Section 704(c).]

   c. It has no unusual affect on the partnership accounts, because the sale is recognized as if it were a sale for cash, and accounts are adjusted accordingly. [This answer is incorrect. Subsequent collections of principal due on the note will be allocated to partners in accordance with the Section 704(c) rules.]

   d. The note receivable related to the sale is subject to Section 704(c), but because it is an installment sale, the partnership is, in effect, allowed to alter the allocation of gain mandated by the Section 704(c) rules. [This answer is incorrect. The partnership is not allowed by Section 704(c) to alter the allocation of gain.]

How to Allocate Gain/Loss Triggered by Certain Distributions of Partnership Property

Distributions of Contributed Property

IRC Sec. 704(c)(1)(B) provides a special rule that applies when contributed property is later distributed to a partner other than the contributing partner. In such case, any precontribution gain or loss may be taxable to the contributing partner. The distribution is treated as a partnership sale of the contributed property for an amount equal to the property's FMV on the distribution date (but only for purposes of determining the contributing partner's gain). Gain or loss is recognized by the contributing partner as if a sale occurred, but the amount of gain or loss recognized is limited to the total precontribution gain or loss. The partnership's tax basis in the property is adjusted to reflect the gain or loss recognized by the contributing partner. Then, the normal distribution rules govern the taxation of the distribution to the distributee partner.

The basic intent of the Section 704(c)(1)(B) rules is to prevent taxpayers from engaging in tax-deferred property swaps outside the boundaries of the Section 1031 rules or other nonrecognition provisions of the Code.

For the remaining discussion in this section, the partner who contributes property that is later distributed to another partner will be referred to as the *contributing partner*. The partner who receives the distribution of the previously contributed property will be referred to as the *distributee partner*.

Reg. 1.704-4 covers the Section 704(c)(1)(B) rules and clarifies the following points:

1. The gain or loss recognized by the contributing partner generally has the same character (ordinary, Section 1231, capital) as the gain or loss that would result from an actual sale of the property by the partnership to the distributee partner on the distribution date. However, if the distributee partner owns more than a 50% interest in partnership capital or profits and does not hold the distributed property as a capital asset, the gain will be ordinary regardless of the nature of the contributed property.

2. The basis of the contributing partner's partnership interest is increased by the gain or decreased by the loss recognized under IRC Sec. 704(c)(1)(B). This basis increase or decrease is taken into account immediately before any distribution to the contributing partner of money or other property that is part of the same distribution as the distribution of the contributed property to the distributee partner.

3. The basis to the partnership of the previously contributed property (that is now being distributed to the distributee partner) is increased or decreased to reflect the gain or loss recognized by the contributing partner. This basis increase or decrease happens immediately before the property is distributed. The partnership and the distributee partner then use the normal tax rules that apply to a distribution of partnership property.

These three steps are illustrated by the following examples.

Example 2E-1 Allocating gain when contributed property is distributed to another partner.

Frankie and Luigi decide to form Two Guys from Sardinia (TGS, a 50/50 general partnership) to enter the restaurant business. Frankie contributes used restaurant equipment with a $50,000 FMV and a $20,000 tax basis ($30,000 precontribution tax gain). Luigi contributes $50,000. The market for used restaurant equipment skyrockets overnight because of unexpected new government regulations that restrict the supply of new restaurant equipment.

Unfortunately, used equipment can be sold only by someone who has the proper license. Luigi has a license, but Frankie and the partnership do not. The partners decide to distribute the equipment to Luigi so he can sell it as quickly as possible. Just before the distribution, Frankie contributes an additional $37,500 and Luigi contributes $112,500 so the partners can speculate, on a 50/50 basis, in used restaurant equipment (after the partnership gets its license to sell such property). Frankie and Luigi decide to forget about actually running a restaurant altogether.

Upon its distribution to Luigi, the used restaurant equipment has a $75,000 FMV. Following is the Section 704(c) capital account analysis allocating the $30,000 deemed tax gain ($75,000 date of distribution FMV less basis of $20,000, limited to the $30,000 amount of precontribution gain):

	Frankie		Luigi		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Initial contributions	$ 50,000	$ 20,000	$ 50,000	$ 50,000	$ 100,000	$ 70,000
Later cash contributions	37,500	37,500	112,500	112,500	150,000	150,000
Deemed gain on distribution	12,500	30,000	12,500	—	25,000	30,000
Property distribution	—	—	(75,000)	(50,000)[a]	(75,000)	(50,000)[a]
Capital	$ 100,000	$ 87,500	$ 100,000	$ 112,500	$ 200,000	$ 200,000

Note:

[a] $20,000 initial tax basis increased by $30,000 gain recognized by Frankie on the distribution.

In effect, 100% of the $30,000 precontribution tax gain is allocated to Frankie. Any other tax allocation would increase the difference between the partners' tax-basis and FMV capital accounts. The objective of the Section 704(c) rules is to equalize the partners' tax-basis and FMV capital accounts as quickly as possible. (The $25,000 discrepancy between the partners' tax-basis capital accounts makes sense because Luigi will recognize 100%, rather than 50%, of the $25,000 postcontribution taxable gain when he eventually sells the distributed property.)

Example 2E-2 Allocating gain when there are more than two partners.

On 1/1/08, Andy, Bill, and Linda join as equal partners to form the Able Partnership to invest in commercially zoned land. Andy contributes $10,000 plus a lot with a $10,000 FMV and a $4,000 tax basis. The other two partners contribute $20,000 each.

On 12/31/10, Able distributes the lot to Bill in partial liquidation of his partnership interest. Assume the lot's FMV is still $10,000 and that from 1/1/08 through 12/31/10, the partnership's taxable gross income and deductible expenses offset each other.

Under the Section 704(c)(1)(B) rules, Andy recognizes $6,000 of taxable gain on 12/31/10. The gain reflects the $6,000 precontribution gain inherent in the lot contributed by Andy. The partnership makes a $6,000 adjustment to the lot's basis just before it is distributed to Bill. This increases the predistribution basis of the lot to $10,000. Accordingly, the tax basis of the distributed lot in Bill's hands is $10,000 under IRC Sec. 732(a)(1). The results are summarized in the following capital account analysis.

	Andy		Bill		Linda		Total	
	FMV	Tax	FMV	Tax	FMV	Tax	FMV	Tax
Initial contributions	$ 20,000	$ 14,000	$ 20,000	$ 20,000	$ 20,000	$ 20,000	$ 60,000	$ 54,000
Gain on distribution	—	6,000	—	—	—	—	—	6,000
Subtotal	20,000	20,000	20,000	20,000	20,000	20,000	60,000	60,000
Property distribution	—	—	(10,000)	(10,000)	—	—	(10,000)	(10,000)
Capital after distributions	$ 20,000	$ 20,000	$ 10,000	$ 10,000	$ 20,000	$ 20,000	$ 50,000	$ 50,000

Example 2E-3 Allocating loss when the ceiling rule applies.

On 1/1/08, Artis, Buster, and Claude join as equal partners to form the Albacore Partnership to invest in residential land. Artis contributes Lot A with a $10,000 FMV and a $5,000 tax basis and Lot B with FMV and tax basis of $10,000. The other two partners contribute $20,000 each.

On 1/1/10, Albacore distributes Lot A to Buster in partial liquidation of his partnership interest. Assume Lot A's FMV has dropped to $7,000. Also assume that from 1/1/08 through 1/1/10 the partnership's taxable gross income and deductible expenses offset each other.

Under the Section 704(c)(1)(B) rules, $2,000 of taxable gain is recognized by Artis on 1/1/10 (the lesser of the $5,000 precontribution gain or the actual gain on the distribution date). The partnership makes a $2,000 adjustment to the lot's basis just before it is distributed to Buster. This increases the lot's predistribution basis to $7,000. Accordingly, the lot's tax basis in Buster's hands is $7,000 under IRC Sec. 732(a)(1).

Assume the partnership uses the traditional method for Section 704(c) allocations. Under this method, both Buster and Claude have $1,000 book losses that cannot be matched with any tax loss because of the ceiling rule. (Under the traditional method, there can be no tax loss allocated to noncontributing partners when there is an overall tax gain on the distribution transaction.)

Accordingly, this transaction creates a permanent difference between the partners' book and tax capital accounts. As shown in Example 2E-4, this problem can be solved if the partnership uses the remedial allocation method for making its Section 704(c) allocations.

The results using the traditional method are summarized in the following capital account analysis.

	Artis		Buster		Claude		Total	
	FMV	Tax	FMV	Tax	FMV	Tax	FMV	Tax
Initial contributions	$ 20,000	$ 15,000	$ 20,000	$ 20,000	$ 20,000	$ 20,000	$ 60,000	$ 55,000
Gain (loss) on distribution	(1,000)	2,000	(1,000)	—	(1,000)	—	(3,000)	2,000
Subtotal	19,000	17,000	19,000	20,000	19,000	20,000	57,000	57,000
Property distribution	—	—	(7,000)	(7,000)	—	—	(7,000)	(7,000)
Capital after distribution	$ 19,000	$ 17,000	$ 12,000	$ 13,000	$ 19,000	$ 20,000	$ 50,000	$ 50,000

Example 2E-4 Allocating loss using the remedial allocation method.

Assume the same facts as in Example 2E-3, except the partnership uses the remedial method for making Section 704(c) allocations. Under the remedial method, the partnership can make remedial allocations of "created out of the air" tax losses of $1,000 each to Buster and Claude to match their book losses. The $2,000 offsetting remedial allocation of "created out of the air" tax income is to Artis. The remedial allocations equalize the book and tax capital accounts.

The remedial losses have the same character as would result from actually selling the distributed property at a loss (capital loss in this example). The remedial allocation of income to Artis has the same character as would result from an actual sale of the distributed property at a gain (capital gain in this example).

The results using the remedial allocation method are summarized in the following capital account analysis.

	Artis		Buster		Claude		Total	
	FMV	Tax	FMV	Tax	FMV	Tax	FMV	Tax
Initial contributions	$ 20,000	$ 15,000	$ 20,000	$ 20,000	$ 20,000	$ 20,000	$ 60,000	$ 55,000
Gain (loss) on distribution	(1,000)	2,000	(1,000)	—	(1,000)	—	(3,000)	2,000
Remedial allocation	—	2,000	—	(1,000)	—	(1,000)	—	—
Subtotal	19,000	19,000	19,000	19,000	19,000	19,000	57,000	57,000
Property distribution	—	—	(7,000)	(7,000)	—	—	(7,000)	(7,000)
Capital after distribution	$ 19,000	$ 19,000	$ 12,000	$ 12,000	$ 19,000	$ 19,000	$ 50,000	$ 50,000

Distribution of Built-in Loss Property

As discussed earlier in this section, the Section 704(c)(1)(B) rules also apply when contributed built-in loss property is distributed to a partner other than the contributing partner. The contributing partner is generally required to recognize a taxable loss equal to the lesser of the excess of the basis of the distributed property over its FMV on the distribution date or the amount of the built-in loss as of the contribution date.

Unfortunately, if the distributee partner owns more than a 50% capital or profits interest in the partnership, the contributing partner's loss is disallowed under IRC Sec. 707(b)(1)(A). (The preamble to Reg. 1.704-4 confirms that this loss disallowance rule applies.) When the loss disallowance rule applies, IRC Sec. 707(b)(1) provides a gain reduction rule whereby the distributee partner can reduce any gain recognized upon a later disposition of the distributed property by the amount of the loss disallowed to the contributing partner at the time of the distribution. (While this gain reduction rule is helpful in an overall tax-saving sense, it does not do the contributing partner any good unless his intent was to use the partnership to shift tax benefits to the distributee partner.)

Exceptions for Certain Distributions

The regulations clarify that the Section 704(c)(1)(B) rules do *not* apply to the following distributions:

1. Distributions of property contributed to a partnership before 10/4/89.

2. Distributions of property more than seven years after the contribution. For this purpose, the seven-year period begins on and includes the contribution date.

3. Distributions that are not covered by the *normal* distribution rules under IRC Secs. 731(a) and 737. In other words, the Section 704(c)(1)(B) rules do *not* apply to distributions covered by other Code sections, such as IRC Secs. 707(a) (partner-partnership transactions including *disguised sales*); 736(a) (certain partnership payments to retiring partners); or 751(b) (certain distributions treated as sales or exchanges under the *hot asset* rules).

4. Certain distributions in complete liquidation of a partner's interest.

5. Complete transfers of partnership assets and liabilities to another partnership.

6. Incorporations of partnerships.

7. Distributions of undivided interests in property to the extent that the undivided interest does not exceed the undivided interest contributed by the distributee partner in the same property.

Special rules apply when the contributing partner receives a property distribution that is of a like kind to the originally contributed property that is now being distributed to the distributee partner. These rules can minimize or eliminate the requirement for the contributing partner to recognize gain under the Section 704(c)(1)(B) rules.

Installment Note Received from the Disposition of Section 704(c) Property

When contributed appreciated property subject to the Section 704(c)(1)(B) rules is sold by the partnership in an installment sale transaction, the resulting note receivable is also subject to the Section 704(c)(1)(B) rules. Therefore, if the note is distributed to a partner other than the partner that contributed the related property, it must be treated as a distribution of an appreciated partnership asset. Therefore, gain must be recognized under the Section 704(c)(1)(B) rules and allocated to the partner that contributed the property that was sold in the installment sale transaction. In other words, arranging an installment sale will not allow the partnership to alter the result mandated by the Section 704(c)(1)(B) rules.

Impact of Assets-over Partnership Merger

In and of itself, an *assets-over* partnership merger will not trigger gain or loss under the Section 704(c)(1)(B) rules because assets are not distributed to partners in such mergers. However, Prop. Reg. 1.704-4(c)(4) says the contribution of appreciated or depreciated property to the transferee partnership in an assets-over merger can create new Section 704(c) gain or loss for certain partners of merging partnerships. To the extent new Section 704(c) gain is created, affected partners are potentially exposed to additional gain recognition under the Section 704(c)(1)(B) rules for distributions that occur up to seven years after the merger. However, under an exception, the Section 704(c)(1)(B) rules will *not* apply to new Section 704(c) gain or loss created by an assets-over merger when the ownership of the transferor and transferee partnerships are identical (as defined) or when the ownership is only different by *de minimis* amounts (as defined).

On another favorable note, Prop. Reg. 1.704-4(c)(4) provides that an assets-over merger does not restart the seven-year period under the Section 704(c)(1)(B) rules for original Section 704(c) gain or loss (i.e., built-in gain or loss that existed when property was originally contributed to a partnership that is later involved in the assets-over merger).

The proposed rules summarized in the preceding discussion apply to partnership distributions that occur after 1/19/05 if such property was contributed in an assets-over merger after 5/3/04.

Distributions to Partners that Previously Contributed Appreciated Property

Under IRC Sec. 737, partners who contribute appreciated property to a partnership may be forced to recognize gain to the extent the value of any property (other than money) subsequently distributed to that partner exceeds the partner's basis in the partnership interest. The Section 737 rules are similar to the Section 704(c)(1)(B) rules and operate on the same principles. It is possible for a contributing partner to be hit with gains under both IRC Secs. 704(c)(1)(B) and 737. This can occur if contributed appreciated property is distributed to another partner and other property is distributed to the contributing partner.

Schedule K-1 Reporting Requirements

An additional Schedule K-1 reporting requirement applies to property distributions that are affected by the Section 704(c)(1)(B) rules. If such a distribution is made, Code W should be entered on line 20 of the contributing partner's Schedule K-1, and a statement should be attached to that partner's Schedule K-1. The statement should disclose the amount of the precontribution gain (loss) and the character of that gain (loss). The partner should then report the gain (loss) amount that must be recognized under the Section 704(c)(1)(B) rules on the partner's Schedule D or Form 4797.

How to Allocate Depreciation and Gains/Losses under IRC Sec. 704(c) and the Ceiling Rule

Background

The most common application of the Section 704(c) rules to deductions is the allocation of tax depreciation, depletion, and amortization (DD&A) with respect to contributed property. Although the goal of all such allocations is to minimize the difference between the contributing partner's FMV and tax-basis capital accounts, the actual allocation amounts may differ depending on whether the partnership uses the traditional method, the traditional method with curative allocations, the remedial allocation method, or some other reasonable method.

Example 2F-1 Depreciation allocations for precontribution gain property.

Steve and Dan form Stevie Dan, Ltd., (a 50/50 partnership) to sell boots. Steve contributes $10,000, and Dan contributes a computer with a $10,000 FMV and a $6,000 tax basis. The computer will be depreciated straight-line over five years for both tax-basis and FMV capital account purposes. The partners agree to use the traditional method to make Section 704(c) allocations. Each year, the partnership expects to break even before considering depreciation expense. Thus, the partnership has a FMV (book) loss of $2,000 per year for the first five years and a tax loss of $1,200 per year for the first five years.

The following Section 704(c) capital account analysis shows how to allocate tax depreciation deductions using the traditional method.

Once the FMV (book) capital account allocations are properly determined, the tax allocations can be made. Tax depreciation is allocated to the partner *without* the book/tax difference (Steve) in an amount equal to his FMV depreciation, and the balance of the tax depreciation (if any) is allocated to the partner *with* the book/tax difference (Dan) as follows:

	Steve		Dan		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Contributions	$ 10,000	$ 10,000	$ 10,000	$ 6,000	$ 20,000	$ 16,000
Year 1 depreciation (equal to net loss)	(1,000)	(1,000)	(1,000)	(200)	(2,000)	(1,200)
Ending capital	$ 9,000	$ 9,000	$ 9,000	$ 5,800	$ 18,000	$ 14,800

This procedure will eventually eliminate the book/tax difference over the computer's depreciation recovery period by allocating more tax depreciation to Steve and less to Dan as follows:

	Steve		Dan		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 1 ending capital	$ 9,000	$ 9,000	$ 9,000	$ 5,800	$ 18,000	$ 14,800
Year 2 depreciation	(1,000)	(1,000)	(1,000)	(200)	(2,000)	(1,200)
Ending capital	8,000	8,000	8,000	5,600	16,000	13,600
Years 3–5 depreciation	(3,000)	(3,000)	(3,000)	(600)	(6,000)	(3,600)
Ending capital	$ 5,000	$ 5,000	$ 5,000	$ 5,000	$ 10,000	$ 10,000

If the partnership is liquidated at the end of Year 5 (assuming the computer has no remaining value), the $10,000 of cash will be distributed equally to the partners per their FMV capital accounts (which are then identical to their tax-basis capital accounts).

Alternatively, if the computer is sold at the end of Year 3 for $5,000, the allocation of the $2,600 tax gain ($5,000 proceeds − $2,400 remaining tax basis) on sale is as follows:

	Steve		Dan		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Year 2 ending capital	$ 8,000	$ 8,000	$ 8,000	$ 5,600	$ 16,000	$ 13,600
Year 3 depreciation	(1,000)	(1,000)	(1,000)	(200)	(2,000)	(1,200)
Gain on sale—special	—	—	—	1,600	—	1,600
Gain on sale—50/50	500	500	500	500	1,000	1,000
Capital	$ 7,500	$ 7,500	$ 7,500	$ 7,500	$ 15,000	$ 15,000

Note that no other tax gain allocation would equalize the FMV and tax-basis capital accounts. The $1,600 special allocation of precontribution tax gain to Dan can be analyzed as follows:

Remaining book basis	$ 4,000
Less: remaining tax basis	(2,400)
Remaining precontribution tax gain to be specially allocated to Dan	$ 1,600

Example 2F-2 Depreciation allocations for precontribution loss property.

Assume the same facts as in Example 2F-1, except the contributed computer has a $20,000 tax basis and a $10,000 FMV. As a result, Dan has a $10,000 precontribution tax loss. Also, assume the computer is depreciated for tax and FMV purposes over five years, straight-line. The partnership will have a $2,000 FMV (book) loss and a $4,000 tax loss for each of the first five years. If the computer is sold at the end of Year 3 for $5,000, the partnership recognizes a $3,000 tax loss ($5,000 proceeds − $8,000 remaining tax basis) and a $1,000 FMV gain ($5,000 proceeds − $4,000 undepreciated FMV).

The tax depreciation allocated to Steve is based on his share of the computer's FMV. Therefore, Steve is allocated only $1,000 of tax depreciation each year (50% of the $10,000 FMV depreciated over five years using straight-line). The remaining $3,000 of annual tax depreciation is allocated to Dan, the contributing partner.

The following Section 704(c) capital account analysis shows how to allocate the tax loss and FMV gain:

	Steve		Dan		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Initial contributions	$ 10,000	$ 10,000	$ 10,000	$ 20,000	$ 20,000	$ 30,000
Years 1–3 depreciation	(3,000)	(3,000)	(3,000)	(9,000)	(6,000)	(12,000)
Book gain on sale	500	—	500	—	1,000	—
Tax loss on sale	—	—	—	(3,000)	—	(3,000)
Capital	$ 7,500	$ 7,000	$ 7,500	$ 8,000	$ 15,000	$ 15,000

The ceiling rule prevents allocating a $500 tax gain to Steve and a $3,500 tax loss to Dan—which would equalize the partners' tax-basis and FMV capital accounts. Whenever a disposition results in a FMV gain and a tax loss (or vice versa), it will be impossible to balance the partners' tax-basis and FMV capital accounts under the traditional method. If the partnership were to liquidate at the end of Year 3, each partner would be distributed $7,500. Steve would recognize a $500 gain ($7,500 distribution − $7,000 tax basis in his partnership interest) upon liquidation. Dan would recognize a $500 loss upon liquidation ($7,500 distribution − $8,000 tax basis in his partnership interest). The operation of the ceiling rule simply defers the $500 tax gain that *should* have been allocated to Steve when the computer was sold until he disposes of his partnership interest. The same is true of the extra $500 tax loss that *should* have been allocated to Dan. Note that the effects of the ceiling rule can be reduced or eliminated by using the traditional method with curative allocations or the remedial method (Examples 2F-4 and 2F-5).

Example 2F-3 Depreciation and loss allocations under the ceiling rule.

Herbert and Bunker decide to form a 60/40 joint venture, Silver Boon Partnership, to speculate in the silver market. Herbert contributes $1.2 million, and Bunker kicks in $400,000 plus a small office building worth $400,000 (its tax basis is only $100,000). The partners use the office building as their headquarters. For simplicity, assume the office building is depreciated over 20 years (using straight-line) for FMV and tax purposes. The partnership decides to use the traditional method to make Section 704(c) allocations.

Unfortunately, Herbert and Bunker's enterprise is a lesson in the risks of commodity speculation. They lose all of their cash in one year. To make matters worse, the office building depreciates in value from $400,000 to $300,000. At the end of Year 1, Silver Boon sells the building for $300,000 and liquidates. The following Section 704(c) capital account analysis shows how to allocate the FMV and tax losses and gains:

	Herbert		Bunker		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Contributions	$ 1,200,000	$ 1,200,000	$ 800,000	$ 500,000	$ 2,000,000	$ 1,700,000
Cash losses	(960,000)	(960,000)	(640,000)	(640,000)	(1,600,000)	(1,600,000)
Depreciation	(12,000)	(5,000)	(8,000)	—	(20,000)	(5,000)
Book loss on building	(48,000)	—	(32,000)	—	(80,000)	—
Tax gain on building	—	—	—	205,000	—	205,000
Capital	$ 180,000	$ 235,000	$ 120,000	$ 65,000	$ 300,000	$ 300,000

Herbert is allocated annual tax depreciation of $5,000 under the ceiling rule. This is 100% of the partnership's annual tax depreciation—which is still less than his 60% share of annual FMV depreciation. Thus, there is no tax depreciation left to allocate to Bunker. Also, when the building is sold, there is a FMV loss ($300,000 proceeds − $380,000 FMV basis) and a tax gain (tax basis at the end of Year 1 is only $95,000). Under the ceiling rule, the $205,000 tax gain must be allocated 100% to Bunker, the contributing partner (to the extent of the remaining difference between book and tax basis). Under the traditional method, it is not permissible to allocate a tax gain to Bunker and a tax loss to Herbert, which would be necessary to equalize their tax-basis and FMV capital accounts.

When Silver Boon liquidates, Herbert will receive $180,000 (60%) and Bunker will receive $120,000 (40%). Herbert recognizes a capital loss of $55,000 upon liquidation, and Bunker recognizes a capital gain of $55,000. Thus, the operation of the ceiling rule only defers the $55,000 tax loss that *should* have been allocated to Herbert upon the sale of the building and the additional $55,000 of tax gain that *should* have been allocated to Bunker at that time.

Example 2F-4 Using curative allocations to minimize the effect of the ceiling rule.

Assume the same facts as in Example 2F-3, except the traditional method with curative allocations is used to make Section 704(c) allocations. Curative allocations of income or expense are made to equalize the FMV and tax depreciation expense allocable to the noncontributing partners. Herbert and Bunker's capital accounts using curative allocations would be as follows:

	Herbert		Bunker		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Contributions	$ 1,200,000	$ 1,200,000	$ 800,000	$ 500,000	$ 2,000,000	$ 1,700,000
Cash losses	(960,000)	(960,000)	(640,000)	(640,000)	(1,600,000)	(1,600,000)
Depreciation	(12,000)	(5,000)	(8,000)	—	(20,000)	(5,000)
Curative allocation of cash losses	—	(7,000)	—	7,000	—	—
Book loss on building	(48,000)	—	(32,000)	—	(80,000)	—
Tax gain on building	—	—	—	205,000	—	205,000
Capital	$ 180,000	$ 228,000	$ 120,000	$ 72,000	$ 300,000	$ 300,000

The difference between Bunker's FMV and tax-basis capital account balance after the sale is only $48,000, as opposed to $55,000 in Example 2F-3. Had the property been held for its entire depreciable life, this method would have completely eliminated the difference between the partners' FMV and tax-basis capital accounts.

The partnership cannot make curative tax allocations of additional cash losses to Herbert and additional cash income to Bunker to equalize the FMV and tax-basis capital accounts at liquidation. This is because, under the curative allocation rules, the cash income allocated to Herbert must be of the same type as gain generated by the sale of the building. In this case, the cash income would be ordinary, and it is assumed the gain on the building's sale would be Section 1231 gain. However, the partnership can solve the problem by using the remedial method to make allocations. See the next example.

Example 2F-5 Depreciation allocations using the remedial allocation method.

Assume the same facts as in Example 2F-3, except the remedial allocation method is used to make Section 704(c) allocations. To the extent of Bunker's tax basis in the building ($100,000), Silver Boon uses the depreciation method and remaining recovery period used by the contributing partner (20 years, straight-line). To the extent the FMV of the contributed building exceeds its tax basis ($300,000), Silver Boon must treat the property as new depreciable property (depreciated using the straight-line method over an assumed recovery period of 40 years for purposes of this example). The partners' FMV and tax-basis capital accounts under these assumptions are as follows:

	Herbert		Bunker		Total	
	FMV	Tax	FMV	Tax	FMV	Tax
Contributions	$ 1,200,000	$ 1,200,000	$ 800,000	$ 500,000	$ 2,000,000	$ 1,700,000
Cash losses	(960,000)	(960,000)	(640,000)	(640,000)	(1,600,000)	(1,600,000)
Depreciation	(7,500)	(5,000)	(5,000)	—	(12,500)	(5,000)
Remedial allocation	—	(2,500)	—	2,500	—	—
Gain (loss) on sale	(52,500)	—	(35,000)	205,000	(87,500)	205,000
Remedial allocation	—	(52,500)	—	52,500	—	—
Capital	$ 180,000	$ 180,000	$ 120,000	$ 120,000	$ 300,000	$ 300,000

The preceding remedial allocations are "created out of thin air" loss on the building's sale to Herbert and "created out of thin air" gain from the building's sale to Bunker. The character of the "created out of thin air" remedial gains and losses is of the same character as would apply to actual gains and losses from the sale of the building.

Example 2F-6 Depreciation allocations involving more than two partners.

Dr. Jeff, Dr. Boyd, and Dr. Sara form a partnership. Dr. Jeff and Dr. Boyd are both 40% partners and Dr. Sara is a 20% partner. Dr. Jeff contributes equipment with a $25,000 FMV, a $10,000 tax basis, and a remaining useful life of five years. Dr. Boyd contributes equipment with a $20,000 FMV, a $15,000 tax basis, and a remaining useful life of four years, plus $5,000. Dr. Sara contributes $12,500 cash. The partnership uses the traditional method to make Section 704(c) allocations. Tax depreciation over the life of the contributed equipment is allocated among the three partners based on the following Section 704(c) capital account analysis:

	Dr. Sara		Dr. Jeff		Dr. Boyd		Total	
	FMV	Tax	FMV	Tax	FMV	Tax	FMV	Tax
Contributions:								
Cash	$ 12,500	$ 12,500	$ —	$ —	$ 5,000	$ 5,000	$ 17,500	$ 17,500
Dr. Jeff's equipment	—	—	25,000	10,000	—	—	25,000	10,000
Dr. Boyd's equipment	—	—	—	—	20,000	15,000	20,000	15,000
Subtotal	12,500	12,500	25,000	10,000	25,000	20,000	62,500	42,500
Depreciation on Dr. Jeff's equipment	(5,000)	(3,333)	(10,000)	—	(10,000)	(6,667)	(25,000)	(10,000)
Depreciation on Dr. Boyd's equipment	(4,000)	(4,000)	(8,000)	(8,000)	(8,000)	(3,000)	(20,000)	(15,000)
Ending capital	$ 3,500	$ 5,167	$ 7,000	$ 2,000	$ 7,000	$ 10,333	$ 17,500	$ 17,500

The preceding depreciation allocations are based on depreciable tax basis equal to FMV (to the extent of 100% of tax basis) for partners who did not contribute the property in question. The contributing partner is allocated any remaining tax depreciation. In the case of Dr. Jeff's equipment, the tax depreciation is allocated $^2/_3$ to Dr. Boyd and $^1/_3$ to Dr. Sara (based on their relative shares of FMV depreciation). After the allocations to Dr. Boyd and Dr. Sara, there is no tax depreciation remaining to be allocated to Dr. Jeff. The tax depreciation on Dr. Boyd's equipment is allocated $8,000 to Dr. Jeff, $4,000 to Dr. Sara, and $3,000 (the remainder) to Dr. Boyd. The reason for the discrepancies in this example between book and tax-basis capital accounts is the ceiling rule. However, these discrepancies can be eliminated if the partnership uses the remedial allocation method.

How to Report on Return

Special allocations of DD&A under the Section 704(c) rules (including any curative or remedial allocations) should not be reported as a separate line item on Schedule K-1. Rather, the amount of DD&A allocated to each partner should be included in the amount of ordinary income or loss reported on the appropriate lines of Schedules K and K-1.

Allocating DD&A When Basis Adjustment Applies to Section 704(c) Property

A partnership basis adjustment is made with respect to a transferee partner when the partnership has a Section 754 optional basis adjustment election in effect. The basis adjustment is allocated to specific partnership assets and is applicable only to the transferee partner (other partners are completely unaffected). In essence, the basis adjustment belongs to the transferee partner.

In some cases, the asset to which a basis adjustment applies will also be subject to the Section 704(c) rules explained in this lesson, because there was a difference between adjusted basis and FMV at the time the asset was contributed to the partnership. Reg. 1.743-1(j)(4) explains how to allocate the resulting tax DD&A for such assets when the partnership uses the remedial method to make its Section 704(c) allocations.

According to the regulation, the transferee partner's positive basis adjustment attributable to any Section 704(c) built-in gain is depreciated or amortized over the remaining recovery period for the property. Any remaining amount of positive basis adjustment is depreciated or amortized as if it were new property of the same character as the underlying partnership asset. The following example illustrates these rules.

Example 2F-7 Remedial method used for Section 704(c) allocations.

Audrey and Benson form an equal partnership. Audrey contributes depreciable property with tax basis of $100,000 and FMV of $500,000. Benson contributes $500,000 cash. Each partner is credited with a $500,000 book (FMV) capital account. The partnership uses the remedial method to make its Section 704(c) allocations.

At the time the partnership is formed, the depreciable property had five years remaining in its MACRS recovery period. Therefore, in computing the partnership's book depreciation expense, book basis of $100,000 will be depreciated over the remaining five years.

If the partnership had purchased the property at the time the partnership was formed, a 10-year MACRS period would have applied. As explained earlier in this lesson, the remaining $400,000 of book basis [the amount equal to the Section 704(c) gain] will be depreciated over 10 years in computing the partnership's book depreciation deduction. Therefore, the total amount of annual book depreciation for the first five years is $60,000 ($100,000 ÷ 5 + $400,000 ÷ 10). For book capital account purposes, Audrey and Benson are each allocated $30,000 of annual depreciation expense.

Assume that, except for the depreciation deductions, the partnership's expenses equal its income in each of the first two years. After two years, the partners' book and tax-basis capital accounts are as follows:

	Audrey		Benson	
	Book	Tax	Book	Tax
Initial contribution	$ 500,000	$ 100,000	$ 500,000	$ 500,000
Year 1 depreciation	(30,000)	—	(30,000)	(20,000)
Year 1 remedial allocation	—	10,000	—	(10,000)
Year 2 depreciation	(30,000)	—	(30,000)	(20,000)
Year 2 remedial allocation	—	10,000	—	(10,000)
Capital	$ 440,000	$ 120,000	$ 440,000	$ 440,000

Now assume Audrey sells her interest at the end of Year 2 to Travis for its FMV of $440,000. The partnership makes a Section 754 election, and accordingly makes a positive basis adjustment of $320,000 with respect to Travis. Under IRC Sec. 755, the entire basis adjustment is allocated to the depreciable property. At the time of the partnership interest transfer, $320,000 of Section 704(c) built-in gain from the property was still reflected on the partnership's books (book basis of $380,000 versus tax basis of $60,000).

This means that Travis's entire basis adjustment is attributable to the remaining Section 704(c) built-in gain. Therefore in computing Travis's tax depreciation, the $320,000 positive basis adjustment is depreciated over the remaining recovery period for the Section 704(c) built-in gain (i.e., eight years). In other words, his annual tax depreciation deduction attributable to the basis adjustment will be $40,000 ($320,000 ÷ 8 years). However, Travis will also receive $10,000 of offsetting annual remedial income allocations in Years 3 through 5 and $20,000 of offsetting annual remedial income allocations in Years 6 through 10 (the same amounts Audrey would have received had she continued as a partner). Benson is completely unaffected by all this.

After 10 years, the property will be completely depreciated for both book and tax purposes. At that point, Benson's book capital account will equal $250,000. Benson's book and tax-basis capital accounts are always equal; therefore, his tax-basis capital account will also equal $250,000.

Travis's tax-basis capital account will also equal $250,000 ($440,000 initial capital less eight years worth of depreciation at $40,000 per year plus three years worth of remedial income allocations at $10,000 per year plus five years worth of remedial income allocations at $20,000 per year). His book capital account will also equal $250,000. This is as it should be, because the purpose of the remedial allocations is to equalize book and tax-basis capital accounts at the end of the day.

Allocating Depreciation Recapture from Contributed Property

Prior to Reg. 1.1245-1, partnerships often allocated income from depreciation recapture among the partners in proportion to the allocation of the overall gain from sale of the recapture property. This procedure could result in allocations of recapture income inconsistent with earlier allocations of depreciation deductions. Under the regulations, a partner's distributive share of recapture income is the *lesser* of—

1. the partner's share of the total gain from sale (as determined under the Section 704 rules), or

2. the partner's share of prior depreciation or amortization deductions (allowed or allowable) for the property.

Any remaining recapture income is allocated among the partners in proportion to (but not in excess of) their shares of the total gain. While the regulations were issued under IRC Sec. 1245, the same rules apply to allocations of Section 1250 depreciation recapture income. The regulations mandate following Section 1245 principles in allocating Section 1250 recapture among partners.

If a partnership interest is transferred, the depreciation recapture potential is also transferred to the new partner unless it is reduced or eliminated by stepping up the transferee partner's share of the basis of partnership property.

When a partner contributes built-in gain property covered by the Section 704(c) rules, the contributing partner's share of prior depreciation or amortization includes the allowed or allowable deductions before the contribution. Therefore, the allocation of recapture income will follow the allocation of gain under the Section 704(c) rules.

Example 2F-8 Allocating depreciation recapture under the traditional method.

Claire and Danny are equal partners in the newly formed CD Partnership (CDP). For her interest, Claire contributes depreciable equipment with a $28,000 FMV and an $8,000 tax basis. The equipment (Property C) is depreciable over five years using the straight-line method, and Claire has claimed $2,000 of tax depreciation (one year's worth) prior to the contribution. Danny contributes $28,000, which is used to buy new equipment (Property D), depreciable over seven years using the straight-line method.

CDP uses the traditional method to allocate tax items attributable to Property C. Under this method, Danny is allocated annual tax depreciation of $2,000 (50% of the annual book amount of $7,000, limited to $2,000 by the ceiling rule). Claire is allocated zero tax depreciation from Property C. Each partner is allocated $2,000 of annual tax depreciation from Property D. Thus, at the end of Year 1 of the partnership, Claire's share of prior tax depreciation from Property C is $2,000 (from her precontribution ownership). Danny's share is also $2,000 (from Year 1 of the partnership). Each partner's share of tax depreciation from Property D is $2,000.

Assume Property C is sold for $30,000 at the end of Year 1. The book gain is $9,000 ($30,000 − $21,000 book basis), which is split equally between Claire and Danny. After the sale, each partner's book capital account is $27,000 ($28,000 contribution − $5,500 book depreciation + $4,500 book gain).

The tax gain from the sale of Property C is $24,000 ($30,000 proceeds − $6,000 tax basis). Under the traditional method, the first $15,000 of tax gain is allocated to Claire (equal to the remaining difference between book and tax basis), and the remaining $9,000 is split equally. Thus, Claire is allocated total tax gain of $19,500 and Danny is allocated $4,500. Of Claire's gain, $2,000 represents depreciation recapture (equal to her precontribution share of prior depreciation from Property C). Danny also has depreciation recapture of $2,000 (equal to his share of depreciation from Property C during partnership year 1). After the sale Claire's tax-basis capital account is $25,500 ($8,000 contribution − $2,000 tax depreciation from Property D + $19,500 tax gain). Danny's tax-basis capital account is $28,500 ($28,000 contribution − $4,000 of tax depreciation from Properties C and D + $4,500 of tax gain). Note that if Property D is also sold at the end of Year 1, each partner's share of depreciation from Property D would be $2,000 for depreciation recapture purposes.

Example 2F-9 Allocating depreciation recapture under the traditional method with curative allocations.

Assume the same facts as in Example 2F-8, except CDP uses the traditional method with curative allocations to allocate Property C tax items. The book results for Year 1 are exactly the same as in Example 2F-8.

The tax results are also the same, *except* Danny is allocated a curative amount consisting of an additional $1,500 of tax depreciation (actually from Property D) so that his book and tax depreciation totals are equal. Claire is allocated $1,500 of curative ordinary income. These curative allocations are for tax purposes only and do not affect the partners' book capital accounts.

When Property C is sold for a $24,000 tax gain, both partners recognize a $4,500 tax gain (equal to their shares of the book gain). Claire also recognizes the $15,000 excess of tax gain over book gain (attributable to the remaining difference between book and tax basis for Property C). Thus, Claire is allocated total tax gain of $19,500 and Danny is allocated $4,500. Of Claire's gain, $500 represents depreciation recapture (equal to her $2,000 precontribution share of prior depreciation from Property C reduced by the $1,500 curative allocation in favor of Danny). Danny has depreciation recapture of $3,500 (equal to his share of depreciation from Property C, including the curative allocation, during partnership Year 1). After the sale Claire's tax-basis capital account is $27,000 ($8,000 contribution − $2,000 tax depreciation from Property D + $1,500 curative allocation + $19,500 tax gain). Danny's tax-basis capital account is also $27,000 ($28,000 contribution − $5,500 of tax depreciation from Properties C and D including the curative allocation + $4,500 of tax gain). Note that if Property D is also sold at the end of Year 1, each partner's share of depreciation from Property D would be $2,000 for depreciation recapture purposes.

Example 2F-10 Allocating depreciation recapture under the remedial method.

Assume the same facts as in Example 2F-9, except CDP uses the remedial method to make allocations of tax items attributable to Property C. Under the remedial method, the Year 1 depreciation for Property C is calculated as $8,000 depreciated over four years ($2,000) plus $20,000 depreciated over five years ($4,000). Thus, Claire and Danny are each allocated $3,000 of depreciation from Property C in Year 1.

Because there is only $2,000 of annual tax depreciation from Property C, Danny receives a remedial allocation of $1,000 in additional depreciation from Property C. Claire receives a remedial allocation of $1,000 of offsetting ordinary income. These remedial allocations are for tax purposes only and do not affect the partners' book capital accounts.

When Property C is sold for $30,000 at the end of Year 1, the book gain is $8,000 (proceeds of $30,000 less book basis of $22,000), which is split equally between Claire and Danny. After the sale, each partner's book capital account is $27,000 [$28,000 contribution − $5,000 of book depreciation ($3,000 from Property C + $2,000 from Property D) + $4,000 of book gain].

When Property C is sold for a $24,000 tax gain, both partners recognize a $4,000 tax gain (equal to their shares of the book gain). Claire also recognizes the $16,000 excess of tax gain over book gain (attributable to the remaining difference between book and tax basis for Property C). Thus, Claire is allocated total tax gain of $20,000 and Danny is allocated $4,000. Of Claire's gain, $1,000 represents depreciation recapture (equal to her $2,000 precontribution share of prior depreciation deductions from Property C reduced by the $1,000 remedial allocation in favor of Danny). Danny has depreciation recapture of $3,000 (equal to his share of depreciation from Property C, including the remedial allocation, during partnership Year 1). After the sale Claire's tax-basis capital account is $27,000 ($8,000 contribution − $2,000 of tax depreciation from Property D + the $1,000 remedial allocation + $20,000 of tax gain). Danny's tax-basis capital account is also $27,000 ($28,000 contribution − $5,000 of tax depreciation from Properties C and D including the remedial allocation + $4,000 of tax gain). Note that if Property D is also sold at the end of Year 1, each partner's share of depreciation from Property D would be $2,000 for depreciation recapture purposes.

Allocations of Unrecaptured Section 1250 Gain

Unrecaptured Section 1250 gain is subject to a maximum federal income tax rate of 25%. When depreciable real property held over one year is sold for a taxable gain, the unrecaptured Section 1250 gain component is that part of the gain that: (1) is attributable to depreciation, and (2) would otherwise be treated as Section 1231 gain eligible for the 15% maximum rate on long-term capital gains in 2010. In other words, it is the gain from depreciation recapture that is *not* required to be treated as ordinary income pursuant to the Section 1250 recapture rule.

Currently, there is no guidance on how unrecaptured Section 1250 gain should be allocated among partners when a partnership sells appreciated real estate. Pending the release of such guidance, it is presumably permissible to follow the guidelines for allocating Section 1245 recapture, as explained in this section.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

47. A 50/50 partnership is formed with Partner A contributing used equipment with FMV $25,000 and $10,000 tax basis, and $18,750 in cash. Partner B contributes $81,250. To circumvent licensing requirements, the partnership distributes the equipment to Partner B. At that time FMV of the equipment was $37,500. What is Partner B's tax basis capital account balance after the distribution?

    a. $81,250.

    b. $56,250.

    c. $50,000.

    d. $43,750.

48. A 50/50 partnership is formed with Partner A contributing $15,000 and Partner B contributing equipment with FMV $15,000 and tax basis $9,000. The equipment will be depreciated for both book and tax bases for five years. The partnership allocates Sec. 704(c) property using the traditional method. The partnership is not expected to make more than break-even before considering depreciation expense. Assume the equipment will be sold at the end of Year 3 for $7,500. What is the allocation of gain on sale of the equipment to Partner B's tax basis capital account?

    a. $750.

    b. $1,500.

    c. $2,400.

    d. $3,150.

49. A 50/50 partnership is formed with Partner A contributing $150,000 and Partner B contributing equipment with FMV $150,000 and tax basis $90,000. The equipment will be depreciated for both book and tax bases for five years. The partnership allocates Sec 704(c) property using the traditional method. The partnership is not expected to make more than break-even before considering depreciation expense. Assume the equipment will be sold at the end of Year 3 for $75,000. What is the allocation of gain on sale of the equipment to Partner A's tax basis capital account?

    a. $31,500.

    b. $24,000.

    c. $15,000.

    d. $7,500.

50. An equal partnership is formed. Partner A contributes depreciable property (five years remaining under MACRS) with FMV $250,000 and tax basis $50,000. Partner B contributes $250,000 cash. The remedial method is used by the partnership to make Sec. 704(c) allocations. Sec. 704(c) gain will be depreciated over 10 years, and book basis will be depreciated over 5 years. Assume, except for depreciation deductions, partnership expenses equal income in each of the first two years. At the end of Year 2, Partner A sells their interest to Partner C for FMV of $220,000. The partnership makes a Sec. 754 election. The resulting basis adjustment of $160,000 is depreciated over the remaining built-in gain recovery period. What is Partner C's annual tax depreciation deduction attributable to the basis adjustment, and how much annual remedial income allocations will Partner C receive in Years 3–5?

   a. $25,000 depreciation and $5,000 annual remedial income.

   b. $30,000 depreciation and $10,000 annual remedial income.

   c. $15,000 depreciation and $10,000 annual remedial income.

   d. $20,000 depreciation and $5,000 annual remedial income.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

47. A 50/50 partnership is formed with Partner A contributing used equipment with FMV $25,000 and $10,000 tax basis, and $18,750 in cash. Partner B contributes $81,250. To circumvent licensing requirements, the partnership distributes the equipment to Partner B. At that time FMV of the equipment was $37,500. What is Partner B's tax basis capital account balance after the distribution? **(Page 105)**

    a. $81,250. [This answer is incorrect. It is the balance before the property distribution.]

    b. $56,250. [This answer is correct. It is the initial contributions, plus the property distribution.]

    c. $50,000. [This answer is incorrect. It is Partner B's book capital account balance after the distribution.]

    d. $43,750. [This answer is incorrect. It is Partner A's balance after the distribution.]

48. A 50/50 partnership is formed with Partner A contributing $15,000 and Partner B contributing equipment with FMV $15,000 and tax basis $9,000. The equipment will be depreciated straight-line for both book and tax bases for five years. The partnership allocates Sec. 704(c) property using the traditional method. The partnership is not expected to make more than break-even before considering depreciation expense. Assume the equipment will be sold at the end of Year 3 for $7,500. What is the allocation of gain on sale of the equipment to Partner B's tax basis capital account? **(Page 109)**

    a. $750. [This answer is incorrect. It is the share of the remaining sale proceeds after allocation of the built-in gain to B.]

    b. $1,500. [This answer is incorrect. It is the total of the sales proceeds remaining after allocation of the built-in gains to B.]

    c. $2,400. [This answer is incorrect. It is the special allocation of built-in gain on property contributed by B.]

    d. $3,150. [This answer is correct. $2,400 is allocated as B's built-in gain, and $750 is B's share of the remaining sale proceeds.]

49. A 50/50 partnership is formed with Partner A contributing $150,000 and Partner B contributing equipment with FMV $150,000 and tax basis $90,000. The equipment will be depreciated for both book and tax bases for five years. The partnership allocates Sec 704(c) property using the traditional method. The partnership is not expected to make more than break-even before considering depreciation expense. Assume the equipment will be sold at the end of Year 3 for $75,000. What is the allocation of gain on sale of the equipment to Partner A's tax basis capital account? **(Page 109)**

    a. $31,500. [This answer is incorrect. $24,000 is allocated as B's built-in gain, and $7,500 is B's share of the remaining sale proceeds.]

    b. $24,000. [This answer is incorrect. It is the special allocation of built-in gain on property contributed by B.]

    c. $15,000. [This answer is incorrect. It is the total of the sales proceeds remaining after allocation of the built-in gains to B.]

    d. $7,500. [This answer is correct. It is the share of the remaining sale proceeds after allocation of the built-in gain to B.]

50. An equal partnership is formed. Partner A contributes depreciable property (five years remaining under MACRS) with FMV $250,000 and tax basis $50,000. Partner B contributes $250,000 cash. The remedial method is used by the partnership to make Sec. 704(c) allocations. Sec. 704(c) gain will be depreciated over 10 years, and book basis will be depreciated over 5 years. Assume, except for depreciation deductions, partnership expenses equal income in each of the first two years. At the end of Year 2, Partner A sells their interest to Partner C for FMV of $220,000. The partnership makes a Sec. 754 election. The resulting basis adjustment of $160,000 is depreciated over the remaining built-in gain recovery period. What is Partner C's annual tax depreciation deduction attributable to the basis adjustment, and how much annual remedial income allocations will Partner C receive in Years 3–5? **(Page 109)**

   a. $25,000 depreciation and $5,000 annual remedial income. [This answer is incorrect. Depreciation over 8 years on $160,000 is $20,000.]

   b. $30,000 depreciation and $10,000 annual remedial income. [This answer is incorrect. Depreciation should be calculated over 8 years, and remedial income is not equal to $10,000.]

   c. $15,000 depreciation and $10,000 annual remedial income. [This answer is incorrect. Depreciation is calculated over 8 years and remedial income in each of Years 3–5 is an amount other than $5,000.]

   d. $20,000 depreciation and $5,000 annual remedial income. [This answer is correct. $160,000 depreciated over 8 years is $20,000, and annual remedial income is calculated over each of Years 3–5 as $5,000.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (T65TG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

39. A partnership is formed with Partner A contributing $500 cash and Partner B contributing land with a FMV of $500, and a tax basis of $300. The partners have equal interest in profits and losses. If the land decreases in value to $450 and the partnership sells it at that price, what is the allocation of tax gain?

    a. The entire tax gain is allocated to Partner A.

    b. The entire tax gain is allocated to Partner B.

    c. The tax gain is allocated to Partner A $175 and to Partner B $25.

    d. The tax gain is allocated to Partner A $25 and to Partner B $175.

40. The small disparity rule under IRC Sec. 704(c) can result in a partnership choosing to—

    a. Avoid application of IRC Sec. 704(c) to contributed properties that have a difference in aggregate FMV and basis of more than 15% for all properties contributed by a single partner during the year.

    b. Avoid application of IRC Sec. 704(c) to properties contributed during the year as long as the total disparity between FMV and basis for all property contributed by a partner is more than $20,000.

    c. Not allocate gain or loss under IRC Sec. 704(c).

    d. Allocate gain or loss under IRC Sec. 704(c) only on acquisition of property.

41. When can gain on the disposition of contributed property be used to make a curative allocation in regard to previous cost recovery deductions?

    a. When the gain creates a capital gain by exceeding the partnership basis of the contributing partner.

    b. When cost recovery deductions are limited by the ceiling rule and the partnership agreement (in effect for the contribution year) allows it.

    c. When the partnership agreement is silent on the issue.

    d. When the majority of the noncontributing partners grant permission.

42. When is use of the remedial allocation method allowed?

    a. Whenever other methods do not yield the needed results in the book capital accounts.

    b. Whenever a partnership is audited.

    c. Only when there is a need to give support to a struggling partner.

    d. Only when there is a book allocation to a noncontributing partner that is different from that partner's tax allocation.

43. Generally, partnerships cannot aggregate contributed property in order to apply Section 704(c) rules. Aggregation is permitted, however, for certain property contributed by one partner during the tax year. Which of the following are permitted to be aggregated?

    a. Built-in gains in certain situations deemed acceptable by the IRS.

    b. Inventory using the specific identification method for valuation.

    c. Depreciable real property.

    d. Real property with zero basis.

44. A 50/50 partnership is formed with Partner A contributing property with a FMV of $50,000 and a tax basis of $250, and Partner B contributing $50,000 cash. Later, the market for the property explodes and the partnership sells it for $125,000. The tax gain recognized by each partner is which of the following?

    a. $250 to A, $50,000 to B.

    b. $87,500 to A, $87,500 to B.

    c. $87,250 to A, $37,500 to B.

    d. $37,500 to A, $37,500 to B.

45. A 50/50 partnership is formed with Partner A contributing $5,000 cash and Partner B contributing property with a FMV of $5,000 and tax basis $3,000. The property is later sold for $2,500. How is the tax loss allocated?

    a. All allocated to B, the contributing partner.

    b. All allocated to A, in accordance with the ceiling rule.

    c. Evenly allocated to A and B, according to the FMV rule.

    d. Since it is a loss, it is allocated to neither partner.

46. How is tax gain or loss allocated when an asset subject to a basis adjustment is also subject to IRC Sec. 704(c) rules?

    a. The transferee partner's gain/loss is that partner's share of partnership gain/loss under IRC Sec. 704(c), minus any positive basis adjustment, plus that partners' negative basis adjustment.

    b. The transferee partner's gain/loss is that partner's share of partnership gain/loss under IRC Sec. 704(c), minus any negative basis adjustment, plus any positive basis adjustment.

    c. The transferee partner's gain/loss is that partner's share of partnership gain/loss under IRC Sec. 704(c), minus any positive basis adjustment.

    d. The transferee partner's gain/loss is that partner's share of partnership gain/loss under IRC Sec. 704(c), plus any positive basis adjustment, plus that partners' negative basis adjustment.

47. Which of the following best describes how a transaction is handled when contributed property with a built-in gain or loss is distributed to a partner other than the contributing partner?

    a. Gain or loss to the contributing partner takes the same character as would occur if the partnership sold the property to the partner to whom the distribution is made.

    b. The contributing partner's interest is not affected by the gain or loss from the sale by the partnership.

    c. Any basis increase or decrease to the contributing partner is considered immediately after any distribution to the distributee partner.

    d. Basis to the partnership of the distributed property is increased or decreased immediately after any distribution to the distribute partner.

48. Three partners form an equal partnership. Partner A contributes $5,000 cash and land with $5,000 FMV and a $2,000 tax basis. Partner B and Partner C each contribute $10,000 cash. Over the next two years, the partnership breaks even each year, and the land's FMV has not changed. The partnership distributes the land to Partner B in partial liquidation of B's interest. How does this transaction affect the tax basis capital accounts of Partners A and B?

    a. It reduces B's account by $5,000 and has no effect on A's account.

    b. It reduces B's account by $5,000 and increases A's account by $3,000.

    c. It reduces B's account by $3,000 and reduces A's account by $3,000.

    d. It increases B's account by $3,000 and increases A's account by $3,000.

49. A 50/50 partnership is formed with Partner A contributing $15,000 cash and Partner B contributing equipment with a FMV of $15,000 and a tax basis of $30,000. The equipment will be depreciated for both book and tax bases for five years. The partnership makes Section 704(c) property allocations using the traditional method. The partnership is not expected to break-even before considering depreciation expense. Assume the equipment will be sold at the end of Year 3 for $7,500. What is the allocation of gain on sale of the equipment to the partners' book and tax basis capital accounts?

    a. Partner A: Book $1,500, Tax $-0-; Partner B: Book $1,500, Tax ($4,500).

    b. Partner A: Book $750, Tax $750; Partner B: Book $750, Tax ($3,000).

    c. Partner A: Book $750, Tax $-0-; Partner B: Book $750, Tax ($4,500).

    d. Partner A: Book $750, Tax ($4,500); Partner B: Book $750, Tax $-0-.

50. A partner's distributive share of depreciation recapture income is which of the following?

    a. The greater of the partner's share of total gain from sale, or the partner's share of depreciation/amortization from contributed property.

    b. An allocation that may exceed their share of total gain.

    c. Calculated without reference to Section 704(c) rules.

    d. The lesser of the partner's share of total gain from sale, or the partner's share of depreciation/amortization from contributed the property.

GLOSSARY

Bifurcated debt: The portion for which one or more partners bear an economic risk of loss is treated as a recourse liability for basis purposes and allocated exclusively to the partner who bears that risk of loss. The remainder is treated as a nonrecourse liability.

Contributing partner: The partner who contributes property that is later distributed to another partner.

Distributee partner: The partner who receives the distribution of the previously contributed property.

Exculpatory liability: A liability that is nonrecourse in that no partner or person related to a partner has any economic risk of loss for the liability, but that is not secured by specific partnership property. Rather, an exculpatory liability is a general recourse liability to the partnership as an entity.

Nonrecourse liability: A partnership liability (or a portion of a liability) for which no partner bears the economic risk of loss.

Partner affiliate: A person is affiliated with a partner if that person (1) is not another partner in the same partnership and (2) shares with the partner one of the relationships described by the attribution rules of IRC Sec. 267(b) or controlled partnership rules of IRC Sec. 707(b)(1), subject to certain modifications set forth in Regs. 1.752-1(a)(3) and 1.752-4(b).

Partner nonrecourse loan: If a partner or related person (i.e., a partner affiliate) makes a loan that would be characterized as nonrecourse if made by an unrelated person, it will be categorized as recourse for basis purposes.

Payment obligation: The requirement to make a payment to a creditor or other person with respect to a partnership liability must be satisfied within a reasonable time after the liability becomes due and payable.

Recourse liability: Under Reg. 1.752-1(a)(1), a partnership liability is deemed a recourse liability to the extent any partner bears the economic risk of loss with respect to the liability.

Remedial allocation method: Under the remedial allocation method, the partnership can, in certain situations, make tax allocations to noncontributing partners of income or gain created out of thin air by the partnership with offsetting allocations to the contributing partner of loss or deduction created out of thin air by the partnership.

Rev. Rul. 96-10: This rule clarifies that if a loss on the sale of partnership property is disallowed under IRC Sec. 707(b)(1), the basis of each partner's interest in the partnership is still decreased (but not below zero) under IRC Sec. 705(a)(2) by that partner's share of the loss.

Rev. Rul. 99-57: This rule indicates that if a corporate partner contributes its own stock to a partnership in exchange for a partnership interest, and the partnership later exchanges the stock in a taxable transaction, then the partnership will realize gain that will be allocated to the partners under IRC Sec. 704.

Significant item of income or gain: A significant class of income or gain. It means that the income or item must be of a particular type or character, such as gain from the sale of property.

Staged pay-in arrangements: When a partner agrees to make contributions in installments or pursuant to a promissory note owed to the partnership.

True nonrecourse liability: No partner bears any risk of economic loss. Consequently, the partners' shares of basis attributable to this type of liability must be determined in a manner other than by analyzing their relative economic risks of loss—the approach used to allocate recourse liabilities.

Wrapped indebtedness: The partnership wraparound liability is treated as owed to the unrelated creditor to the extent of the amount of the underlying wrapped indebtedness. This results in the wrapped indebtedness being treated as a true nonrecourse liability that can be allocated to all partners for basis purposes.

Zero basis rule: This rule limits the basis assigned to property received in distributions.

INDEX

A

ADMISSION OF NEW PARTNER
- Liabilities, allocation of ... 63

APPRECIATED (OR DEPRECIATED) PROPERTY
- Contribution to partnership ... 81
- Effect on allocations ... 81, 82, 83, 96, 105

B

BASIS
- Contributed property
  - FMV and basis not equal ... 81, 82, 83, 96, 105, 109
- Liabilities
  - Effect on outside basis ... 33, 34, 42, 50, 61, 63
- Outside basis
  - Effect of liabilities ... 33

C

CAPITAL ACCOUNTS
- Contribution of property
  - Appreciated ... 81, 82, 83, 96, 105, 109
  - Section 704(c) rules ... 81, 82, 83, 96, 105, 109
- Depreciation
  - Book versus tax ... 81, 82, 83, 96, 105, 109
- Negative
  - Obligation to restore ... 42
- Section 704(c) rules ... 81, 82, 83, 96, 105, 109

CEILING RULE LIMITATION
- Applying to sale of property ... 82
- Depreciation allocation ... 109
- Gain or loss allocation ... 96
- Permissible allocation methods ... 83, 109
- Tiered partnership considerations ... 83

CONTRIBUTION OF PROPERTY
- Allocations related to ... 81, 82, 83, 96, 105, 109
- Appreciated in value ... 81
- Ceiling rule limitation
  - Precontribution gain or loss ... 82, 83, 96
- Depreciation or amortization of ... 109
- FMV and basis unequal ... 81, 82, 83, 96, 105, 109
- Gain or loss
  - Allocations of ... 81, 82, 83, 96, 105, 109
  - Section 704(c) rules ... 81, 82, 83, 96, 105, 109
- Precontribution gain or loss
  - Allocation of ... 81, 82, 83, 96, 105, 109
  - Depreciation, effect on ... 109
- Section 704(c) allocations ... 81, 82, 83, 96, 105, 109
- Unequal FMV and basis ... 81, 82, 83, 96, 105, 109

D

DEBT
- Allocation of for basis purposes
  - In general ... 33

DEFINITION OF TERMS
- Exculpatory liabilities ... 34, 50
- Liabilities ... 33
- Nonrecourse liability ... 50
- No value liquidation ... 42
- Partner affiliate ... 34
- Recourse liability ... 42
- Section 752 rules ... 33

DEPRECIATION
- Allocation of
  - Ceiling rule, effect of ... 109
  - Precontribution gain property ... 109
  - Precontribution loss property ... 109
  - Section 704(c) rules ... 82, 83, 96, 105, 109
- Book versus tax
  - Capital accounts, effect on ... 96
- Precontribution gain or loss, effect on depreciation ... 109
- Tax versus book
  - Capital accounts, effect on ... 109

DISTRIBUTIONS
- Contributed property, distribution of ... 105
  - Anti-abuse rule ... 105
  - Coordination of IRC Secs. 704(c)(1)(B) and 737 ... 105
  - Exceptions for certain distributions ... 105
- Encumbered property ... 63
- Gain or loss allocation from ... 105
- Reporting of gain/loss from ... 105
- Section 704(c) rules ... 105

G

GAIN OR LOSS
- Allocation of
  - Contributed property ... 81, 82, 83, 96, 105, 109
- Contributed property
  - Allocation of gain or loss ... 81, 82, 83, 96, 105, 109
  - Ceiling rule limitation ... 82, 83, 96
- Disposition of contributed property ... 81, 82, 83, 96, 105, 109
- Distribution
  - Of partnership property, allocation as a result of ... 105
  - Specific situations and examples ... 83
- Reporting of gain or loss from distributions ... 105

GUARANTEES
- *De minimis* rule ... 61
- Interest guarantees ... 61
- Nonrecourse debt, of ... 61
- Partial guarantee ... 61
- Recourse debt, of ... 61
- Tantamount to a guarantee ... 61

L

LIABILITIES
- Allocation of basis from
  - Bifurcated debt ... 34
  - Consistency rule ... 34
  - *De minimis* rule ... 34
  - Effective dates of Section 752 rules ... 34
  - Exculpatory debt ... 34, 50
  - Grandfathered debt ... 34
  - Guarantees by partner affiliate ... 34
  - Guarantees, effect of ... 61
  - In general ... 33
  - Interest guarantee, effect of ... 61
  - Loans from partner affiliates ... 34
  - Master lease agreement, effect of ... 61
  - Nonrecourse, *de minimis* rule ... 34
  - Nonrecourse loan ... 34, 50
  - No value liquidation—defined ... 42
  - *Old* versus *new* rules ... 34
  - Partner affiliate ... 34
  - Partner's economic risk of loss ... 42
  - Qualified nonrecourse financing ... 34
  - Recourse ... 42
  - Wrapped indebtedness ... 34
- Basis, effect of liabilities on ... 33, 34, 42, 50, 61,63
- Cash-basis liabilities ... 33
- Contingent debt ... 33
- Definition ... 33
- Duty of consistency principle ... 34
- Economic risk of loss
  - In general ... 42
  - Special allocations, effect of ... 42
- Effective dates of Section 752 rules ... 34
- Effect of partnership termination ... 34
- Effect on exchanging partnership property ... 63
- Exculpatory liabilities ... 34, 50
- Guarantees of
  - By partners ... 34, 61
  - *De minimis* rule ... 61
  - Effect of on basis ... 34, 61
  - Interest ... 61
  - Tantamount to ... 34, 61
- Nonrecourse
  - Allocating true nonrecourse liabilities ... 50
  - Allocation to partners for basis purposes ... 34, 50
  - Definition ... 50
  - *De minimis* rule ... 34, 50
  - Effective dates of rules ... 34

- •• *Excess* nonrecourse debt . . . 50
- •• Guarantee, effect on basis . . . 34, 61
- •• In general . . . 50
- •• Master lease agreement, effect of . . . 61
- •• Minimum gain . . . 50, 63
- •• Partner affiliate nonrecourse loans . . . 34, 50
- •• Partner has economic risk of loss . . . 50
- •• Partner's share of minimum gain . . . 50
- •• Qualified nonrecourse financing . . . 34
- •• Safe harbor rules . . . 50
- •• Summary of rules . . . 34
- •• Treatment for basis purposes . . . 50
- •• Wrapped indebtedness . . . 34
- • Nonrecourse loans from partners, effect on basis . . . 34, 50
- • Recourse
- •• Allocation of for basis purposes . . . 34, 42, 61
- •• Allocation to limited partners . . . 42
- •• Definition . . . 42
- •• Economic risk of loss . . . 42
- •• Effective dates of rules . . . 34
- •• Guarantee, effect on basis of . . . 42, 61
- •• No value liquidation defined . . . 42
- •• Payment obligation limited to property . . . 42
- •• To limited partner . . . 42
- •• Treatment for basis purposes . . . 34, 42, 61
- •• Valuation of net payment . . . 42
- • Recourse versus nonrecourse . . . 34
- • Regulations on liability assumptions . . . 65
- • Related party debt
- •• Allocation of basis from . . . 34, 61
- • Short sale of securities by partnership . . . 33
- • Transactions tantamount to guarantees . . . 34
- • Transactions that reallocate partnership liabilities . . . 61
- • Wrapped indebtedness, allocation of for basis purposes . . . 34

M

MASTER LEASES
- • Potential effect on basis . . . 61

MINIMUM GAIN
- • Allocation of basis from debt related to . . . 50
- • Calculation of . . . 50

MORTGAGED PROPERTY
- • Effect on partners' bases in their interests . . . 34

P

PARTNER
- • Admission of new . . . 63

PROPERTY
- • Appreciated or depreciated in value . . . 81
- • When FMV and basis differ . . . 81, 82, 83, 96, 105, 109

R

RECEIVABLES
- • Cash basis
- •• Contribution of . . . 82

RELATED PARTIES
- • Partner affiliate, definition of for basis from debt rules . . . 34, 61

S

SALE OR EXCHANGE
- • Gain or loss—See GAIN OR LOSS
- • Of contributed property . . . 81, 82, 83, 96, 105, 109

SECTION 704(b)
- • Minimum gain . . . 50
- • "Section 704(c) principles" . . . 105

SECTION 704(c)
- • Aggregation of contributed property . . . 83
- •• Special rules for securities partnerships . . . 83
- • Allocation of depreciation recapture . . . 109
- • Allocations
- •• Remedial allocation method . . . 83, 96, 105, 109
- •• Traditional method . . . 83, 96, 105, 109
- •• Traditional with curative allocations . . . 83, 96, 105, 109
- • Anti-abuse rule . . . 83
- • Capital accounts, effect on . . . 81, 82, 83, 96, 105, 109
- • Ceiling rule . . . 82, 83, 96
- • Contribution of depreciated property . . . 83
- • Depreciation allocation rules . . . 109
- • Disposition of partnership property . . . 96
- • Distributed property, application of IRC Sec. 704(c) . . . 105
- • Documenting precontribution built-in gains and losses . . . 83, 96
- • Effective date rules . . . 81
- • Exception for small disparities between FMV and basis . . . 83
- • Exceptions for certain property . . . 105
- • In general . . . 81, 82, 83, 96, 105, 109
- • Installment sales . . . 96, 105
- • Minimum gain . . . 50
- • Reporting affected distributions . . . 81, 105
- • Reporting specially allocated depreciation . . . 109
- • Section 754 basis adjustments, interaction with
- •• Depreciation/amortization allocations . . . 109
- •• Gain/loss allocations . . . 109
- • Tiered partnerships . . . 83
- • Unreasonable allocation methods . . . 83

SECTION 752 RULES
- • Definition . . . 33
- • Effect on outside basis . . . 33

T

TIERED PARTNERSHIPS
- • Section 704(c) considerations . . . 83

COMPANION TO PPC'S 1065 DESKBOOK

COURSE 2

Administrative Matters (T65TG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course examines administrative matters related to partnerships and Form 1065. Lesson 1 discusses how to select a tax year under the available sets of rules. Lesson 2 looks at issues related to accounting methods, such as changing accounting methods and electing the accrual method. Lesson 3 examines tax elections for partnerships. Finally, Lesson 4 covers issues related to the tax matters partner, amended returns, and other due diligence matters, such as penalties.

PUBLICATION/REVISION DATE: November 2010

RECOMMENDED FOR: Users of *PPC's 1065 Deskbook*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of tax preparation for partnerships

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

8 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes

EXPIRATION DATE: Postmark by **November 30, 2011**

KNOWLEDGE LEVEL: Intermediate

Learning Objectives:

Lesson 1—Selecting the Tax Year

Completion of this lesson will enable you to:
- Determine a partnership's year-end using required year rules and the nonconforming tax year rules, and determine if it is a member of a tiered structure.
- Identify how to make a Section 444 election, how a partnership would deal with a short tax year, and the tax year for a member of a tiered partnership.

Lesson 2—Accounting Methods

Completion of this lesson will enable you to:
- Determine the limitations on use of the cash method of accounting.
- Elect the accrual method and identify requirements to change from the cash to the accrual method of accounting.

- Identify the IRS requirements to change depreciation methods and correct errors.

Lesson 3—Partnership Tax Elections

Completion of this lesson will enable you to:
- Make a check-the-box election and identify when to elect out of partnership tax provisions.
- Utilize the simplified filing rules for electing large partnerships and extensions on the time allowed for making an election.

Lesson 4—The TMP, Amended Returns, and Due Diligence in Form 1065 Preparation

Completion of this lesson will enable you to:
- Identify the rules related to tax matters partners (TMPs) and requesting administrative adjustments.
- Determine partnership and nonpartnership items, including the statute of limitations for partnership items.
- Identify issues that might result in penalties and ways to avoid them.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
T65TG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Selecting the Tax Year

INTRODUCTION

In 1986, Congress determined all partnerships, S corporations, and personal service corporations should generally have the same tax years as their owners. Later modifications to this concept permitted many entities, including partnerships, to retain their existing fiscal years or to elect other fiscal years if certain conditions were met. This lesson covers the basic rules for selecting, retaining, and changing partnership tax years.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine a partnership's year-end using required year rules and the nonconforming tax year rules, and determine if it is a member of a tiered structure.
- Identify how to make a Section 444 election, how a partnership would deal with a short tax year, and the tax year for a member of a tiered partnership.

Understanding the Rules for a Partnership Year-End

Adopting a Tax Year

A partnership establishes an annual period as its tax year by (a) maintaining its books and records on the same period, and (b) filing the initial tax return based on that period. If books and records are not maintained to establish a fiscal year, the partnership must use a calendar year.

A tax year is adopted by filing the first federal income tax return using that tax year. Accordingly, filing an application for an employer identification number, filing an extension, or making estimated tax payments indicating a particular tax year does not constitute the adoption of that year.

The initial return cannot include more than 12 months but may include fewer months, resulting in a short year.

Limitations on the Use of a Fiscal Year

Limitations exist on the ability of partnerships to use fiscal year-ends. The rules for determining a partnership's permitted year-end are complex and are applied in a step-by-step process summarized below.

Newly Formed Partnerships (in the First Year)

1. *Determine the partnership's required year.* The partnership must use this year unless items 2 or 3 apply. Even if the *required year* is not used, certain rules and limitations drive off of it such as determining the allowable year-end when making a Section 444 election. Thus, the *required year* must always be determined unless the partnership adopts a business purpose year-end.

2. *Determine if the partnership has a business purpose for a nonconforming year-end.* Newly formed partnerships cannot take advantage of the natural business year exception. If a business purpose year is requested, a backup Section 444 election should be considered.

3. *If item 2 does not apply or is unattractive, the partnership can make a Section 444 election for its first tax year.* The elected year cannot have a deferral period of more than three months with respect to the partnership's *required year*. A Section 444 Election may mean the partnership must make tax deposits with the IRS.

4. *If the partnership fails to make a Section 444 election for its first year and uses the required year it cannot make a Section 444 election in a later year, except to retain an existing year-end if the required year changes.*

5. *In most cases, the partnership will find it must use the calendar year.*

Existing Partnerships (after the First Year)

1. *Determine the partnership's required year.* This is the year the partnership must use unless items 2 or 3 apply. Even if the *required year* is not used, certain rules and limitations drive off of it. Thus, the *required year* must always be determined on an annual basis unless the partnership is using a natural business year or business purpose year.

2. *Determine if the partnership can (or wants to) take advantage of the natural business year or business purpose exceptions.* If the partnership has been using a *required year* and if these exceptions do not apply or are unattractive, the tax year cannot be changed unless a Section 444 election has previously been made.

3. *If the partnership's required year changes, a Section 444 election can be made to retain the existing year-end.* The deferral period of the retained year with respect to the new *required year* cannot exceed three months. Existing partnerships using a *required year* cannot make a Section 444 election for a new year-end unless the *required year* changes. If the deferral period of the existing year-end is *more* than three months with respect to the new required year-end, the partnership *cannot* use a Section 444 election to retain the existing tax year. In this case, the partnership's only alternative to the new *required year* is to adopt a new year (or retain the existing year) under the natural business year or business purpose exceptions.

4. *If a partnership was using a nonconforming year because it made a previous Section 444 election and the required year changes, it can continue to use the existing year-end as long as the deferral period is no more than three months.* Retention of the existing year-end is made by filing a new Section 444 election. If the new *required year* results in a deferral period of more than three months when compared to the existing year-end, the partnership cannot retain its existing year-end. However, it may be able to adopt a new year-end.

5. *If the partnership was using a nonconforming year because it made a previous Section 444 election and its required year changes, a new year can be adopted by making a new Section 444 election.* The deferral period of the new year-end cannot exceed the lesser of (a) three months (with respect to the new *required year*), or (b) the deferral period of the year to be changed with respect to the new *required year*.

6. *Partnerships using a natural business year or business purpose year can make a Section 444 election to change to a new year.* The deferral period (with respect to the *required year*) cannot exceed the lesser of (a) three months, or (b) the deferral period of the year being changed.

7. *Partnerships that are part of a tiered structure may be unable to make a Section 444 election.* However, the natural business year and business purpose exceptions are available.

8. *In most cases, the partnership will find it must use the calendar year.*

Applying the Rules for a Required Year-End

Partnerships generally must apply the following hierarchy when determining the required tax year:

- *Majority Interest Rule.* The partnership must adopt the tax year of the partners who own, in the aggregate, more than 50% of the capital and profits interest.

- *Principal Partners Rule.* If no partner, or combination of partners, owning more than 50% of the profits and capital interests has the same tax year, the partnership tax year must be the same as that of the principal partners. Principal partners are those owning 5% or more in either profits or capital interests.

- *Least Aggregate Deferral of Income Rule.* If neither the majority interest rule nor the principal partners rule applies, the partnership must select a tax year resulting in the least aggregate deferral of income to the partners.

The year resulting from one of the above rules is the required year. Despite these rules, partnerships can elect a year-end other than the required year-end by passing certain tests. In any case, the first step in determining the partnership's year-end options is determining the required year.

Tax Years of Partnerships with Foreign or Tax-exempt Partners

Under Reg. 1.706-1(b)(6), any interests held by disregarded foreign partners are not taken into account in determining the partnership's tax year-end. A foreign partner is disregarded unless such partner is allocated any partnership gross income that was effectively connected (or treated as effectively connected) with a trade or business in the U.S. during the partnership's tax year immediately preceding the current tax year (or, if such partner was not a partner during the partnership's immediately preceding tax year, the partnership reasonably believes that the partner will be allocated any such income during the current tax year) and taxation of that income is not otherwise precluded under any U.S. income tax treaty.

A minority interest rule in Reg. 1.706-1(b)(6)(iii) provides that the tax years of foreign partners are not disregarded under IRC Sec. 706(b) if no single partner (other than a disregarded foreign partner) holds a 10% or greater interest in the capital or profits of the partnership, and if, in the aggregate, the partners that are not disregarded foreign partners do not hold a 20% or greater interest in the capital or profits of the partnership.

Under Reg. 1.706-1(b)(5) a partner that is tax-exempt under IRC Sec. 501(a) is similarly disregarded if that partner was not subject to tax, under Chapter 1 of the Code, on any income attributable to its investment in that partnership during the partnership's tax year immediately preceding the current year.

Majority Interest *Required Year* Rule

If a year-end can be determined under the majority interest rules, it is the *required year* for the partnership. The majority interest rule provides that a partnership must adopt the same tax year as the partner(s) who, cumulatively, own "more than 50%" of the partnership's profits and capital interests.

If a partnership changes its tax year to comply with the majority interest rule (because of any changes in the tax years of majority partners), no further change is required for the next two tax years. This is a consistency rule for purposes of determining whether the ownership structure meets the majority interest rule, the test date is the first day of the partnership's tax year.

Example 1B-1 Majority interest rule applies.

The ABC Partnership is comprised of three partners. J and F each own 30% of the capital and profits; and R owns 40%. J and F each have a May 31 year-end; R has a July 31 year-end. Since partners owning more than 50% of the partnership's capital and profits interests have the same year-end, the partnership's *required year* ends on May 31.

Example 1B-2 Majority interest rule does not apply.

The RSTU Partnership has four equal partners. R and S have a June 30 year-end; T and U have a September 30 year-end. Since more than 50% of the partnership's capital and profits interests are *not* owned by partners with the same tax year, the majority interest rule does not apply, and the *required year* must be determined by reference to either the principal partners rule or the least aggregate deferral of income rule.

Principal Partners *Required Year* Rule

If the majority interest rule does not apply, the partnership's *required year* must be the same as that of all of its principal partners. A principal partner is any partner with a 5% or more capital or profits interest. Changes in principal partners or in their year-ends may change the partnership's *required year*. Therefore, the principal partners rule must be applied on an annual basis.

Example 1B-3 Principal partners have same year-ends.

The Elite Partnership has 18 partners. Five of the partners each own 10% of the profits and capital and have April 30 year-ends. Twelve of the partners, each owning a 4% interest, have calendar year-ends. The remaining partner, with a 2% interest, has an October 31 year-end. Since all of the principal partners (those owning more than 5% of the profits or capital interests) have the same year-end, the partnership's required year-end must be April 30. This is true even though the principal partners do not own a majority interest in capital or profits.

Example 1B-4 Principal partners have different year-ends.

Strange Partnership has four equal partners. Two partners have May 31 year-ends. The remaining two partners have September 30 year-ends. Since all of the principal partners do not have the same year-end, the partnership cannot determine its *required year* based on the principal partners rule. (The partnership does not fall under the majority interest rule either.) Accordingly, the partnership must determine a tax year resulting in the least aggregate deferral of income to the partners. That year will be the required year.

Example 1B-5 Principal partners own minority interest.

The Unique Partnership has one partner with a 35% capital and profits interest and a July 31 year-end. Each of the other partners owns less than 3% of the partnership's capital and profits and has a calendar year-end. It might initially appear the partnership year-end should be July 31, since that is the sole principal partner's year-end. However, the capital and profits interests of all the other partners exceed 50% of total partnership profits and capital. Since all the other partners have calendar year-ends, the majority interest rule applies instead of the principal partner rule. Thus, the partnership's *required year* ends on December 31.

Least Aggregate Deferral of Income *Required Year* Rule

If both the majority interest rule and the principal partners rule are inapplicable, the partnership must select a required year-end (from among the partners' year-ends) resulting in the least aggregate deferral of income to the partners. In determining the appropriate year-end under this rule, the year-end and the profits interest of each partner must be taken into account. However, as mentioned earlier, generally any interests held by disregarded foreign partners and partners that are tax-exempt under IRC Sec. 501(a) are not taken into account in determining the partnership's tax year-end.

The determination of the least aggregate deferral of income is made by multiplying each partner's percentage of partnership profits for the year by the number of months of deferral that would arise through the selection of the proposed tax year. Months of deferral for this purpose are counted by going forward from the proposed partnership year-end to the partners' year-ends, using the information available at the beginning of the current tax year (unless the partners have made voluntary changes in their year-ends). After testing each proposed tax year, the tax year that produces the least aggregate deferral of income is the *required year*. If the test produces more than one qualifying tax year, the partnership can select any one of those years. However, if one of the year-ends meeting the test is the partnership's existing year-end, the partnership must retain its existing tax year. There is a special rule that applies to 52-53 week tax years.

A special *de minimis* rule provides that if the tax year with the least aggregate deferral produces an aggregate deferral that is less than .5 (see Example 1B-6 for how the computation is made) of the aggregate deferral of the partnership's existing tax year, the existing tax year will be treated as the tax year with the least aggregate deferral. Thus, no change in tax year is necessary or permitted.

Example 1B-6 Least aggregate deferral calculation.

Fred, Bill, Steve, and Tom form a partnership. Fred has an April 30 year-end, Bill has a July 31 year-end, Steve has a November 30 year-end, and Tom has a December 31 year-end. Fred, Bill, and Steve each own 30% of the partnership; Tom owns 10%. The determination of which year-end must be used is as follows:

Partner	Partner's Year-end	Profits Interest	Months Deferred	Deferral
Fred's April 30 Year-end				
Fred	4/30	.3	—	.0
Bill	7/31	.3	3	.9
Steve	11/30	.3	7	2.1
Tom	12/31	.1	8	.8
Aggregate deferral				3.8

Partner	Partner's Year-end	Profits Interest	Months Deferred	Deferral
Bill's July 31 Year-end				
Fred	4/30	.3	9	2.7
Bill	7/31	.3	—	.0
Steve	11/30	.3	4	1.2
Tom	12/31	.1	5	.5
Aggregate deferral				4.4
Steve's November 30 Year-end				
Fred	4/30	.3	5	1.5
Bill	7/31	.3	8	2.4
Steve	11/30	.3	—	.0
Tom	12/31	.1	1	.1
Aggregate deferral				4.0
Tom's December 31 Year-end				
Fred	4/30	.3	4	1.2
Bill	7/31	.3	7	2.1
Steve	11/30	.3	11	3.3
Tom	12/31	.1	—	.0
Aggregated deferral				6.6

Since the April 30 year-end yields the least aggregate deferral of income, the partnership must select an April 30 year-end for its *required year*.

Example 1B-7 Special *de minimis* rule prevents change in year-end.

Assume the same facts as in Example 1B-6. However, the partnership has been in operation for a number of years and has an existing November 30 year-end. Under the special *de minimis* rule, the tax year will not change, since the tax year resulting in the least aggregate deferral (April 30) produces a difference in aggregate deferral that is less than .5 (4.0 − 3.8 = .2) when compared to the aggregate deferral of the partnership's current November 30 tax year.

Example 1B-8 Several year-ends with least aggregate deferral.

Mary and Sue want to form a partnership. Mary has a calendar year-end, and Sue has a fiscal year ending June 30. Each will own 50% of the partnership's capital and profits. Since both partners' tax years produce the same aggregate deferral (3.0), the partnership can use either partner's year-end as its required year-end.

Example 1B-9 Partnership must continue to use current year-end under consistency rule.

The same facts apply as in Example 1B-8 except the partnership has been in operation for a number of years and presently has a June 30 year-end. Since the partnership has an existing year-end the same as one of the permitted least aggregate deferral year-ends, the partnership must use its current June 30 year-end.

Impact of Partners' Year-end Changes on Partnership's *Required Year*

Unless the partnership has obtained IRS approval for its natural business year or has a business purpose for using another tax year-end, a change in a partner's year-end will often force the partnership to change its year-end. However, in some cases a partnership using a *required year* may be able to retain that year even if its *required year* changes. Also, partnerships that have made previous Section 444 elections may be able to retain the existing year-end or adopt a new *nonconforming* year-end if the *required year* changes.

Example 1B-10 Required year-end change under the majority interest rule.

ABC Partnership has three equal partners and is using the *required year*. All the partners have a June 30 year-end. Two partners obtain permission to change their year-ends to May 31. Since partners owning more than 50% of capital and profits have a new year-end, the partnership is required to change its year-end. However, since the partnership must change its year-end under the majority interest rule, it will not be required to change again (because of later changes in the year-end of partners holding a majority interest) for the two years following the year of change.

Example 1B-11 Required year-end change under the principal partners rule.

A partnership has several partners and has been using the *required year*. Its principal partner, with a 50% capital and profits interest, has a March 31 year-end. None of the remaining partners own more than 3% of the partnership, and they have several different tax year-ends. The partnership thus has a March 31 required year-end under the principal partners rule. For valid business reasons, the principal partner elects to change his tax year to June 30. Since the principal partner has changed his tax year, the partnership must also change its tax year to June 30.

Example 1B-12 Existing year-end retained for valid business purpose.

Assume the same facts as in Example 1B-11, except the partnership has obtained IRS approval to retain the March 31 year-end for a valid business purpose. Since the IRS has approved the tax year-end, the partnership is not required to change even though the principal partner changes his year-end. The same would be true if the partnership were using a natural business year.

Adoption of a Year-end for a New Partnership

A new partnership may adopt its required tax year, a tax year elected under IRC Sec. 444, or a 52-53 week year that relates to its required tax year or tax year that could be elected under IRC Sec. 444, without prior IRS approval by filing Form 1065 and entering the year-end on the form. In any other case, a newly formed partnership must secure prior approval from the IRS for the adoption of a tax year-end.

Recognizing When a Partnership's Required Year Changes

The partnership's required year can change for the following three reasons:

1. The partners holding majority interests change (or their year-ends change).

2. The principal partners change.

3. The year-end with the least aggregate deferral changes. (There is a consistency rule and a *de minimis* rule that may avoid the need to change in some cases.)

Example 1B-13 Recognizing a required change of year-end under the majority interest rule.

The Domino Partnership has been using a September 30 required year-end because the three equal partners have a September 30 year-end. Two partners obtain permission to change their year-ends to March 31. Since partners owning more than 50% of capital and profits now have a March 31 year-end, the partnership must change its year-end as well. But since the change is made under the majority interest rule, no further change in Domino's tax year (due to changes in majority partners' tax years) will be required for the two tax years following the year of change [IRC Sec. 706(b)(4)].

Example 1B-14 Recognizing a required change of year-end under the principal partners rule.

The Iron Men Partnership has been using a required year-end of June 30 because its principal partner, with a 50% interest in capital and profits, has a June 30 year-end. None of the remaining partners owns more than 3%, and they have several different tax year-ends. For valid business reasons, the principal partner elects to change its tax year to March 31. Since the principal partner has changed its tax year, Iron Men must also change to a March 31 year-end.

Automatic Approval Process for Adoption, Change, or Retention of Tax Year

Rev. Proc. 2006-46 contains the procedures under which the IRS will grant a partnership automatic approval for an adoption, change, or retention of a tax year. A partnership complying with the provisions of this revenue procedure is deemed to have established a business purpose and obtained the approval of the Commissioner to adopt, change, or retain its tax year. The procedure generally provides that a partnership has automatic approval for a change in its tax year in the following circumstances:

1. The partnership wants to change to its required tax year or to a 52-53 week tax year ending with reference to the required year.

2. The partnership wants to change to or retain a natural business year that satisfies the 25% gross receipts test or to a 52-53 week tax year ending with reference to that year.

3. The partnership wants to change from a 52-53 week tax year that references a particular calendar month to a tax year that ends on the last day of the same calendar month, or vice versa.

A change of tax year under the revenue procedure is not available if the partnership has changed its tax year within the 48-month period ending with the last month of the requested tax year. For this purpose, a change to the required year (or ownership tax year) or a change to or from a 52-53 week year ending with reference to the same calendar month does not constitute a change in tax year.

To comply with the terms of the revenue procedure, the partnership must complete and file a Form 1128 and should write at the top of the form "FILED UNDER REV. PROC. 2006-46." The completed form must be mailed to Director, Internal Revenue Service, Attention: ENTITY CONTROL, where the partnership files its federal income tax return no earlier than the day following the end of the first effective year and no later than the due date (including extensions) for filing the federal income tax return for the first effective tax year. A general partner who has personal knowledge of the facts must sign the Form 1128. A user fee is not required. The partnership also must timely file a tax return for the short period required to effect the change and attach a copy of the Form 1128. The partnership then must file subsequent tax returns for full 12-month periods ending on the last day of the requested tax year. A change that does not qualify for automatic approval under this revenue procedure must be made under Rev. Proc. 2002-39.

Applying the Rules for Nonconforming Tax Years

Exceptions to the required year rules allow partnerships to use a nonconforming tax year. A nonconforming tax year is one other than the required year. A partnership that wants to change, adopt, or retain its tax year-end under Rev. Proc. 2002-39 must comply with the terms and conditions outlined in Secs. 5.04 and 5.05 (as modified by Notice 2002-72 and Rev. Proc 2003-34). The exceptions are as follows:

1. A partnership can use a tax year other than its required year by establishing that the alternative year is a natural business year. Rev. Proc. 2002-39 establishes the rules for determining if a partnership qualifies to adopt a nonconforming tax year based on a natural business year.

2. If a partnership cannot meet the natural business year exception, it can attempt to establish a business purpose for the use of a year other than its required year. The determination of whether a business purpose exists is based on all relevant facts and circumstances, including tax consequences of electing the alternative year. Rev. Proc. 2002-39 establishes the rules for determining if a partnership qualifies to adopt a nonconforming tax year based on a business purpose.

3. A newly formed partnership can make a Section 444 election to use a nonconforming year if the deferral period is not more than three months.

4. An existing partnership using its required year cannot make a Section 444 election to change to a nonconforming year. However, the partnership may be able to make a Section 444 election to retain its existing year if the required year changes.

5. An existing partnership that has made a previous Section 444 election may be able to retain its existing year or adopt a new nonconforming year when its required year changes.

6. A partnership may have a tax year other than its required year if it elects to use a 52-53 week tax year that ends with reference to its required year.

Natural Business Year Exception

A partnership can apply for a nonautomatic change in tax year if it can show it has a natural business year. A partnership has a natural business year if it qualifies under any of the following:

- The annual business cycle test.
- The seasonal business test.
- The 25% gross receipts test.

If a partnership has a natural business year under any of these three tests and agrees to comply with the terms and conditions outlined in Rev. Proc. 2002-39, the request for a change to the partnership's natural business year will be approved. This revenue procedure does not apply to certain partnerships—for instance, those under examination by the IRS (unless permission is received) or those with partners under examination (if the partnership's tax year is an issue under consideration). See the revenue procedure if these scenarios apply.

Facts and Circumstances Business Purpose Exception

Partnerships that do not have a natural business year can attempt to establish a business purpose for using a tax year other than its required year. In reviewing a request for a tax year based on the business purpose exception, the Service considers all relevant facts and circumstances including the tax consequences of permitting the requested tax year. The statute does not say what qualifies as a business purpose. In Rev. Proc. 2002-39, the Service indicates that a taxpayer will be granted permission to adopt, change, or retain a tax year under the facts and circumstances test only in rare and unusual circumstances. Specifically, the following reasons are not considered business purposes:

1. To use a year-end that defers income for partners.

2. To use the same year-end used for regulatory or financial accounting purposes.

3. To use a year-end that reflects hiring patterns of a business.

4. To use a year-end that reflects other administrative concerns such as retirement of partners, admission of partners, promotion of staff, compensation or retirement arrangements with partners or staff, etc.

5. To use a year-end that reflects the date of the publication of price lists, model changes, or similar events occurring on an annual basis.

6. To use a year-end that reflects the year-end used by a related entity.

7. To use a year-end that reflects the year-end used by a competitor.

8. To use a year-end because the accountant is too busy at a particular time of the year.

Example 1C-1 Qualifying a business year under the facts and circumstances test.

Whitewash Partnership has a required year ending September 30 and has no natural business year. The partnership wants to change to a July 31 year-end because:

1. Its inventories are at the lowest level at that time and are easier to count.

2. August 1 is the start of the new model year.

3. The firm's tax practitioner will reduce the audit fee by 10% if Whitewash changes its year-end.

Additionally, all the partners will be able to defer significant tax liabilities.

The business purpose test probably is not met because the reasons given are of the type the IRS will not consider per Rev. Proc. 2002-39. Consequently, Whitewash probably is stuck with its September 30 required year, unless it wants to consider a Section 444 election.

Requesting a Year Based on a Business Purpose

A partnership seeking to retain a tax year, change its tax year, or adopt a tax year on the basis of the business purpose test, including the natural business year tests, must file Form 1128 (Application to Adopt, Change, or Retain a Tax Year). A general partner must sign the form on behalf of the partnership. If the partnership changed its tax year at any time within the most recent 48-month period ending with the last month of the requested tax year, a copy of the application for the previous change, the ruling letter, and any other related correspondence from the IRS should be attached to the application.

If a prior application was withdrawn, not perfected, or denied, or if the change in tax year was not made, and the partnership files another application to change its tax year within the most recent 48-month period ending with the last month of the requested tax year, a copy of the earlier application, together with any related correspondence with the IRS must be attached to the application. The filer should also attach an explanation of why the earlier application was withdrawn or not perfected or why the change was not made. If the partnership requests a natural business year under the annual business cycle test or the seasonal business test, it must provide its gross receipts and approximate inventory costs (where applicable) for each month in the requested short period and each month in the three immediately preceding tax years. If the partnership requests a natural business year under the 25% gross receipts test, it must supply the gross receipts for the most recent 47 months for itself (or any predecessor).

<u>When to File.</u> A partnership electing to request a new tax year under the provisions of Rev. Proc. 2002-39 must file Form 1128 no earlier than the day following the end of the first effective tax year (the short tax year). Form 1128 must be filed no later than the due date (not including extensions) of the federal income tax return for the short year. However, the IRS recommends that the Form 1128 be filed as early as possible to provide the IRS adequate time for a response. [In the case of a change to or from a 52-53 week year that results in a short year of six days or less, Form 1128 must be filed no earlier than the day following the end of the short period and no later than the due date (not including extensions) of the federal income tax return for the short year, even though the short period is not treated as a separate tax year under Reg. 1.441-2(b)(2).]

A taxpayer that fails to file a Form 1128 within the prescribed time period may request an extension of time to file under Reg. 301.9100-1, -2, and -3. Under Reg. 301.9100-3, a Form 1128 filed within 90 days after the filing deadline may be considered timely filed if the partnership establishes that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. If a Form 1128 is filed more than 90 days after the filing deadline, it will be approved only in unusual and compelling circumstances. If an incomplete Form 1128 is filed, the IRS will inform the applicant of the information required to complete the form and the applicant will be given 21 days from the date of notification to provide the information.

***Nonconforming* Year Based on a Section 444 Election**

The final alternative to using the *required year* is to elect a year-end other than the *required year* by filing a Section 444 election. Under IRC Sec. 444, partnerships can elect to adopt, change, or retain tax year-ends other than required year-ends. New partnerships can elect to adopt a tax year other than the *required year*, provided the deferral period is not more than three months. Existing partnerships not using the *required year* can elect to change their tax years to a new year-end, provided the deferral period is the shorter of three months or the deferral period of the tax year being changed. For example, a partnership using a natural business year can change its tax year under IRC Sec. 444 as long as it satisfies the required conditions.

IRC Sec. 444 defines *deferral period* as the number of months from the end of the elected tax year to the end of the *required year*. The *deferral period of the tax year being changed* means the deferral period of the existing tax year with respect to the current *required year*. For example, assume that a partnership that has historically used a March 31 year-end wants to change to a September 30 year-end by making a Section 444 election for the tax year beginning 4/1/10. Furthermore, assume that the partnership's required year for the tax year beginning April 1 is a year ending December 31. Based on these facts, the deferral period of the tax year being changed is nine months (i.e., the period from March 31 to December 31).

Section 444 Election Options for Existing Partnerships (after the First Year)

1. *An existing partnership using a required year cannot make a later Section 444 election to change its tax year.* However, if the partnership's *required year* changes, it can elect to retain the existing year if the deferral period does not exceed three months.

2. *An existing partnership that has made a previous Section 444 election and is using a nonconforming year can elect to retain its existing year-end if the required year changes.* However, the deferral period of the retained year with respect to the new *required year* cannot exceed three months.

3. *An existing partnership using a nonconforming year because of a previous Section 444 election can elect a new nonconforming year if the required year changes.* However, the deferral period of the new year-end cannot exceed the lesser of (a) three months (with respect to the new *required year*), or (b) the deferral period of the existing year-end with respect to the new *required year*.

4. *Partnerships using nonconforming years based on a natural business year or business purpose can elect to change their year-ends under IRC Sec. 444.* The only limitation is that the deferral period of the new year cannot exceed the greater of (a) three months, or (b) the deferral period of the existing tax year being changed.

5. *Finally, partnerships in existence in 1986 could elect to retain their existing tax year-end.*

When Is a Section 444 Election Beneficial?

A Section 444 election results in a tax deferral as long as the partnership's taxable income increases from year to year. This is because the required payment for the current year is based on the income of the prior year. With the maximum individual rate of 35% for 2010, and the resulting required payment percentage of 36%, it may no longer make sense to keep a Section 444 election in place. Even if the partnership's income is increasing, the required payment may be prohibitive, particularly where the partners are in lower tax brackets. The required payment is, in effect, prepaid taxes that earn no interest, making the cost of the Section 444 election even higher. While no good general rule exists, some factors to consider in deciding whether to make or keep a Section 444 election are:

1. The length of the deferral period versus the payment amount.

2. Whether the increase in income will continue at the present rate, or whether the rate of increase in income will stop or decrease.

3. The impact of the election on state tax deferral. (If the state has no required payment rules, the state tax deferral alone might make the Section 444 election attractive.)

4. The prospect of continuing income versus loss from the partnership.

5. The partners' current and projected tax brackets compared to the required payment percentage.

6. The fact that once the Section 444 election is terminated, it cannot be made again.

As a general rule, high tax bracket owners of a business with rapidly growing levels of taxable income may benefit from the Section 444 election. A business with stagnant or declining profitability should not make the election.

Practical considerations may also influence the decision to change the fiscal year. For instance, some logistical problems may be encountered in changing internal financial reporting to conform to the new fiscal year. The following are some of the other considerations:

a. Partner Year-end Planning. The elected year-end may put the practitioner in a better position to do year-end planning at the partner level. If, for example, the partnership had a September 30 year-end, the pass-through income on which the partner must pay tax could be estimated with greater accuracy than if the entity had a December 31 year-end. Thus, the partner will have more meaningful numbers for year-end planning purposes.

b. Return Preparation. The partnership's practitioner may be able to file tax returns sooner if the tax year ends during a time that is not busy (for example, a September 30 year-end as opposed to a December 31 year-end).

c. Professional Fees. The election can avoid additional professional fees that might otherwise result if an entity with a fiscal year for financial reporting purposes were forced to adopt a calendar year for tax purposes. However, the election could result in additional accounting fees from the computation of the required entity-level tax deposit payments.

If the tax deferral benefits are minimal or nonexistent in relation to the costs, the partnership should consider revoking its Section 444 election by adopting the required year (generally the calendar year). The following example illustrates how to make this analysis.

Example 1C-2: Measuring the benefits and costs of a Section 444 election.

ABC Partnership's required tax deposit payment amount to keep its Section 444 election in effect for the current year (10/1/09 to 9/30/10) is $35,000. Having that amount on deposit with the government is advantageous only if the foreseeable tax deferral benefits are worth more than $35,000, after discounting by an appropriate time value of money factor.

Assume ABC earns taxable income of $150,000 during the last three months of calendar year 2009. (This amount should be known well before the 5/15/10 deadline for filing Form 8752 to keep the Section 444 election in effect for the current year.) Further assume that all of ABC's partners are calendar year taxpayers in the 35% marginal tax bracket. Therefore, keeping ABC's Section 444 election in place will allow its partners to defer $150,000 of taxable income from calendar year 2009 into calendar year 2010.

The tax deferral benefits are worth at least $52,500 (35% y $150,000) to ABC's partners, before discounting that amount to its present value. If the appropriate time value of money discount factor is 15%, the discounted present value of the tax deferral benefits is $45,650 ($52,500 P 1.15). That amount comfortably exceeds the required tax deposit payment of $35,000, assuming that the expense for the necessary calculations for filing Form 8752 is not excessive.

Variation: Now assume the discounted present value of deferring taxable income earned by ABC Partnership during the last three months of calendar year 2009 is $35,000 or less. Even so, it might still be advantageous to pay the required tax deposit amount to keep the Section 444 election in place. This would be the case if ABC is expected to earn a large amount of taxable income during the last three months of calendar year 2010. The ABC partners can effectively defer that income from calendar year 2010 into calendar year 2011, if the partnership's Section 444 election is maintained.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. The Millman partnership is in its first year of existence. In which of the following circumstances, would the partnership **not** need to use its required year?

   a. The partnership is part of a tiered structure.

   b. The partnership adopts a natural business year-end.

   c. The partnership adopts a business purpose year-end.

   d. The partnership will always need to determine its required year.

2. In most cases, an existing partnership must use which of the following as its tax year?

   a. Calendar year.

   b. Fiscal year.

3. Which of the following rules is applied first when determining a partnership's required year?

   a. Least aggregate deferral of income rule.

   b. Majority interest rule.

   c. Principal partners rule.

4. The existing tax year will be treated as the tax year with the least aggregate deferral if it produces an aggregate deferral that is less than .5 of the aggregate deferral of the partnership's existing tax year. Bob, Joe, Jim, and Andy form a partnership. Bob has an April 30 year-end, Joe has a July 31 year-end, Jim has a November 30 year-end, and Andy has a December 31 year-end. Bob's aggregate deferral is 3.2, Joe's aggregate deferral is 3.5, Jim's is 3.9, and Andy's is 4.2. Which of the following is accurate regarding the partnership's selection of a year-end date for its *required year*?

   a. The partnership may select any year-end date that it chooses for its *required year*.

   b. The partnership must select a December 31 year-end for its *required year*.

   c. The partnership must select an April 30 year-end for its *required year*.

5. A new partnership may adopt any of the following tax year-ends without prior approval from the IRS except:

   a. A tax year that could be elected under IRC Sec. 444.

   b. A tax year it elects under IRC Sec. 444.

   c. A 52-53 week year related to its required tax year.

   d. A tax year it elects under IRC Sec. 706(b)(4).

6. In which of the following situations will the IRS grant a partnership automatic approval for the change, adoption, or retention of a tax year?

   a. Alpha Partnership wants to change to a 52-53 week tax year that ends with reference to its required year.

   b. Beta Partnership wants to change to its required tax year, but it has not established a business purpose or obtained the Commissioner's approval.

   c. Gamma Partnership wants to retain a natural business year that satisfies the 15% gross receipts test.

7. What revenue procedure applies to partnerships that want to adopt a nonconforming tax year based on either a natural business year or a business purpose?

   a. Rev. Proc. 2001-10.

   b. Rev. Proc. 2004-34.

   c. Rev. Proc. 2002-39.

   d. Rev. Proc. 2006-46.

8. A partnership must file which of the following forms to change its tax year on the basis of the business purpose test?

   a. Form 1128.

   b. Form 3115.

   c. Form 8716.

   d. Form 8752.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. The Millman partnership is in its first year of existence. In which of the following circumstances, would the partnership **not** need to use its required year? **(Page 133)**

   a. The partnership is part of a tiered structure. [This answer is incorrect. Per Section 444 election rules, a member of a tiered structure must use its required year, unless two exceptions apply.]

   b. The partnership adopts a natural business year-end. [This answer is incorrect. If the Millman partnership was an existing partnership (past its first year of operations), it would have to determine its required year on an annual basis, unless it used a natural business year or business purpose year under a Section 444 election.]

   c. The partnership adopts a business purpose year-end. [This answer is correct. Even if the required year is not used, certain rules and limitations drive off of it, such as determining the allowable year-end when making a Section 444 election. Thus, the required year must always be determined unless the newly formed partnership adopts a business purpose year-end.]

   d. The partnership will always need to determine its required year. [This answer is incorrect. There are certain circumstances under which both a newly formed partnership and an existing partnership would not need to determine their required year.]

2. In most cases, an existing partnership must use which of the following as its tax year? **(Page 134)**

   a. Calendar year. [This answer is correct. There are cases where a fiscal year-end may be used by both newly formed and existing partnerships, but the rules are complex and must be applied in a step-by-step process to determine if a fiscal year-end may be used. In the majority of cases, however, the partnership must use the calendar year.]

   b. Fiscal year. [This answer is incorrect. Limitations exist on the ability of partnerships to use fiscal year-ends and the rules for determining a partnership's permitted year-end are complex; however, fiscal year-ends are not permitted in most cases.]

3. Which of the following rules is applied first when determining a partnership's required year? **(Page 135)**

   a. Least aggregate deferral of income rule. [This answer is incorrect. Under the least aggregate deferral rule, the partnership's required year is the year-end resulting in the least aggregate deferral of income to the partners. This rule is the third level of the hierarchy under the IRC for determining a partnership's required year, so it would only come into effect if the first two rules did not apply.]

   b. Majority interest rule. [This answer is correct. Per the IRC, the majority interest rule is applied first when determining a partnership's required year. If a year-end can be determined under the majority interest rules, this is the partnership's required year.]

   c. Principal partners rule. [This answer is incorrect. The principal partners rule is the second level of the hierarchy for determining a partnership's required year. It would only come into effect if the first level of the hierarchy does not apply. If the first rule does not apply, a partnership's required year must be the same as that of all of its principal partners.]

4. The existing tax year will be treated as the tax year with the least aggregate deferral if it produces an aggregate deferral that is less than .5 of the aggregate deferral of the partnership's existing tax year. Bob, Joe, Jim, and Andy form a partnership. Bob has an April 30 year-end, Joe has a July 31 year-end, Jim has a November 30 year-end, and Andy has a December 31 year-end. Bob's aggregate deferral is 3.2, Joe's aggregate deferral is 3.5, Jim's is 3.9, and Andy's is 4.2. Which of the following is accurate regarding the partnership's selection of a year-end date for its *required year*? **(Page 136)**

   a. The partnership may select any year-end date that it chooses for its *required year*. [This answer is incorrect. Per IRC Sec. 501(a), the partnership may *not* select whatever year-end date for its required year that it chooses. It must select the year-end date that yields the least aggregate deferral of income for its required year.]

   b. The partnership must select a December 31 year-end for its *required year*. [This answer is incorrect. A December 31 year-end does not yield the least aggregate deferral of income and, therefore, cannot be used by the partnership for its required year.]

   c. The partnership must select an April 30 year-end for its *required year*. [This answer is correct. Since the April 30 year-end yields the least aggregate deferral of income, the partnership must select an April 30 year-end for its required year.]

5. A new partnership may adopt any of the following tax year-ends without prior approval from the IRS **except**: **(Page 138)**

   a. A tax year that could be elected under IRC Sec. 444. [This answer is incorrect. A new partnership may adopt a tax year that could be elected under IRC Sec. 444 without prior IRS approval by filing Form 1065. This is a tax year that is allowed to be elected under IRC Sec. 444.]

   b. A tax year it elects under IRC Sec. 444. [This answer is incorrect. By filing Form 1065 and entering a tax year it elects under IRC Sec. 444, a new partnership may adopt a tax year it elects under IRC Sec. 444.]

   c. A 52-53 week year related to its required tax year. [This answer is incorrect. One example of a tax year a new partnership may adopt without prior approval from the IRS by filing Form 1065 is a 52-53 week year related to its required tax year.]

   d. A tax year it elects under IRC Sec. 706(b)(4). [This answer is correct. IRC Sec. 706(b)(4) addresses a required change of year-end under the majority interest rule, not tax year-ends that may be adopted by a new partnership.]

6. In which of the following situations will the IRS grant a partnership automatic approval for the change, adoption, or retention of a tax year? **(Page 139)**

   a. Alpha Partnership wants to change to a 52-53 week tax year that ends with reference to its required year. [This answer is correct. Under the provisions of the revenue procedure that deals with automatic approval of a tax year change, this is one situation that qualifies for such approval. If Alpha Partnership wanted to change to its required tax year instead of the 52-53 week tax year, that change would also be automatically approved.]

   b. Beta Partnership wants to change to its required tax year, but it has not established a business purpose or obtained the Commissioner's approval. [This answer is incorrect. To comply with the provisions of the revenue procedure that allow for an automatic approval of adoption, change, or retention of a tax year, a partnership must have established a business purpose and obtained the approval of the Commissioner to adopt, change, or retain its tax year.]

   c. Gamma Partnership wants to retain a natural business year that satisfies the 15% gross receipts test. [This answer is incorrect. Gamma Partnership would need to satisfy the 25% gross receipts test, not 15%, to qualify for automatic approval of this tax year change.]

7. What revenue procedure applies to partnerships that want to adopt a nonconforming tax year based on either a natural business year or a business purpose? **(Page 139)**

   a. Rev. Proc. 2001-10. [This answer is incorrect. In Rev. Proc. 2001-10, the IRS announced that small businesses with average gross receipts of $1 million or less can use the cash method of accounting.]

   b. Rev. Proc. 2004-34. [This answer is incorrect. Under Rev. Proc. 2004-34, accrual basis taxpayers may elect to defer taxability of advance payments received in connection with services, and in some cases for nonservices.]

   c. Rev. Proc. 2002-39. [This answer is correct. A partnership can use a tax year other than its required year by establishing that the alternative year is a natural business year. If it cannot meet the natural business year exception, the partnership can attempt to establish a business purpose for the use of a year other than its required year. Rev. Proc. 2002-39 establishes the rules for making both of these determinations.]

   d. Rev. Proc. 2006-46. [This answer is incorrect. Rev. Proc. 2006-46 contains the procedures under which the IRS will grant a partnership automatic approval for an adoption, change, or retention of a tax year.]

8. A partnership must file which of the following forms to change its tax year on the basis of the business purpose test? **(Page 141)**

   a. Form 1128. [This answer is correct. A partnership seeking to retain a tax year, change its tax year, or adopt a tax year on the basis of the business purpose test, including the natural business year tests, must file Form 1128 (Application to Adopt, Change, or Retain a Tax Year).]

   b. Form 3115. [This answer is incorrect. A partnership required to change to the accrual method of accounting must attach Form 3115 (Application for Change in Accounting Method) to the return for the year of change.]

   c. Form 8716. [This answer is incorrect. Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year) must be completed in order to make a Section 444 election.]

   d. Form 8752. [This answer is incorrect. A partnership electing a year-end other than its required year-end must make payments and file Form 8752 (Required Payment or Refund Under Section 7519).]

Making a Section 444 Election

A Section 444 election is made by filing Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year). (Form 1128 is not required.) Form 8716 must be filed by the earlier of (1) the 15th day of the fifth month following the month that includes the first day of the tax year for which the election will first be effective, or (2) the due date, without extensions, of the income tax return for the first year resulting from the Section 444 election. Additionally, a copy of Form 8716 must be attached to the partnership return for the first tax year for which the election is made. Form 8716 needs to be filed only for the first year that the election applies.

Backup Section 444 Elections

New partnerships attempting to obtain approval of a *nonconforming* tax year on the basis of a business purpose can make a backup Section 444 election. The backup election, which will become effective if the requested business purpose year-end is denied, is made by filing Form 8716 and typing or printing "BACKUP ELECTION" on the top of the form. However, if the Form 8716 is filed on or after the date the Form 1128 is filed, Form 8716 must have printed or typed across the top "FORM 1128 BACKUP ELECTION."

If the requested year is denied, the backup election is activated by filing Form 8752 (Required Payment or Refund Under Section 7519) and making the required payment. The form must be filed and the required payment made by the later of (1) the normal due date of the required payment, or (2) 60 days from the date the IRS denies the business purpose year-end request.

Payments (or Refunds) That Are Required after Making the Section 444 Election

A partnership electing (under IRC Sec. 7519) a year-end other than its required year-end must make payments and file Form 8752 (Required Payment or Refund Under Section 7519). Payments are required even if a Section 444 election was made only to retain an existing year (i.e., when the partnership's *required year* changed). A partnership using a natural business year or a business purpose year does not need to make required payments. In essence, the required payments constitute a prepaid tax deposit based on the projected cumulative tax deferral from the use of the *nonconforming* year-end for the preceding year. When the deferred tax liability increases, an additional payment must be made. When the deferred tax liability decreases, a refund can be obtained. Required payments are made, and refunds are obtained by filing Form 8752.

The Tax Year for a Member of a Tiered Partnership

General Rule

A member of a tiered structure cannot elect to have any year other than a *required year*. A tiered structure exists when a partnership, S corporation, or personal service corporation (PSC) owns directly (or is owned directly by) another partnership, S corporation, PSC, or trust. However, grantor trusts and trusts treated like grantor trusts are excluded from this definition.

Exceptions

There are two major exceptions to the general rule. The *upstream de minimis* rule provides ownership of a partnership (the *owned* partnership) by a partnership, S corporation, PSC, or trust is disregarded if these entities directly own (cumulatively) 5% or less of the *owned* partnership. The *downstream de minimis* rule applies to ownership by such entities if the income from *owned* partnerships, S corporations, PSCs, or trusts (cumulatively) is less than 2% of the gross income or less than 5% of the adjusted taxable income (including separately stated items and guaranteed payments) of the partnership owning the interest.

The second exception permits the election of a *nonconforming* tax year if the tiered structure consists only of partnerships, S corporations, or both, and if all component members of the tiered structure have the same tax year.

Example 1F-1 Principal partners *required year* rules apply to tiered-structure partnership.

A partnership has two 24% partners, both are S corporations and both have March 31 year-ends. The other partners have various year-ends. None of the other partners owns more than a 2% interest. The partnership is part of a tiered structure and is required to have a March 31 year-end under the principal partners rule. No *nonconforming* year-end is allowed under IRC Sec. 444 because none of the exceptions apply.

Example 1F-2 Majority interest *required year* rules apply to tiered-structure partnership.

A partnership has three equal partners. One is a corporation with an October 31 year-end, another is an individual with a December 31 year-end, and the third is a partnership with a December 31 year-end. The partnership is part of a tiered structure. Since none of the exceptions apply, the partnership has a December 31 *required year* (under the majority interest rule) that cannot be changed by making a Section 444 election.

Applying the Short Tax Year Rules

Short Tax Years

Changing to a fiscal year or changing from a fiscal year to a calendar year creates a short tax year. Short tax years also can occur when a partnership is faced with a technical termination, a liquidation, a merger, or division.

Example 1G-1 Applying the short tax year rules when changing from a fiscal year-end to a calendar year-end.

Ryan and Roger are equal owners of RR Partnership with a September 30 year-end. Due to the tough economic times, RR has revamped its retail sales business and, as a result, the partnership no longer meets its current natural business year of September 30th. Therefore, RR has to change its tax-year end to the calendar year. RR files Form 1065 for the period 10/1/09 through 9/30/10. In addition, a second Form 1065 must be filed for the short period 10/1/10 through 12/31/10.

On their respective 2010 Form 1040s, Ryan and Roger will include the pass-through income from RR for the three months ending 9/30/10, as well as the income received from the short period return ending 12/31/10.

Depreciation

For short tax years, depreciation is determined by multiplying the normal deduction by the ratio that the number of months in the short period bears to 12. (This provision does not apply to the depreciation deduction for real property placed in service or disposed of in the short-period year.) The depreciation deduction for subsequent years is calculated in the normal manner. In the last tax year of the recovery period, the depreciation deduction is the remaining amount of deprecation not previously taken. The Section 179 deduction need not be reduced, even if the tax year is a period of less than 12 months.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Generally, a member of a tiered structure cannot elect to have any year other than its required year. However, which of the following rules provide an exception to this regulation?

   a. Majority interest rule.

   b. Principal partners rule.

   c. Least aggregate deferral of income rule.

   d. *Upstream de minimis* rule.

10. How is depreciation determined for the last tax year of the recovery period?

    a. By multiplying the normal deduction by the ratio the number of months in a short period bears to 12.

    b. The depreciation deduction equals the remaining amount of deduction not taken previously.

    c. The depreciation is determined in the normal manner.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Generally, a member of a tiered structure cannot elect to have any year other than its required year. However, which of the following rules provide an exception to this regulation? **(Page 150)**

   a. Majority interest rule. [This answer is incorrect. Under the majority interest rule, the partnership must adopt the tax year of the partners who own, in the aggregate, more than 50% of the capital and profits interest.]

   b. Principal partners rule. [This answer is incorrect. According to the principal partners rule, if no partner, or combination of partners, owning more than 50% of the profits and capital interests has the same tax year, the partnership tax year must be the same as that of the principal partners.]

   c. Least aggregate deferral of income rule. [This answer is incorrect. According to the least aggregate deferral of income rule, if neither the majority interest rule nor the principal partners rule applies, the partnership must select a tax year resulting in the least aggregate deferral of income to the partners.]

   d. *Upstream de minimis* rule. [This answer is correct. The *upstream de minimis* rule provides ownership of a partnership (the owned partnership) by a partnership, S corporation, personal service corporation (PSC), or trust is disregarded if these entities directly own (cumulatively) 5% or less of the owned partnership.]

10. How is depreciation determined for the last tax year of the recovery period? **(Page 151)**

   a. By multiplying the normal deduction by the ratio the number of months in a short period bears to 12. [This answer is incorrect. Multiplying the normal deduction by the ratio the number of months in a short period bears to 12 is the method of determining depreciation for short tax years but not in the last year of a recovery period.]

   b. The depreciation deduction equals the remaining amount of deduction not taken previously. [This answer is correct. The depreciation deduction does not need to be calculated because any depreciation amount that was not previously taken becomes the depreciation deduction for the last tax year of the recovery period; thus, the depreciation becomes self-evident based on the depreciation taken prior to the last tax year.]

   c. The depreciation is determined in the normal manner. [This answer is incorrect. Depreciation is determined in the normal manner for tax years other than a short tax year, or the last tax year of the recovery period but depreciation must be calculated differently in the last year of a recovery period.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (T65TG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. In its first year of operations, the Rogers Family Partnership used its required year. It did not make a Section 444 election. In the partnership's second year of operations, the required year stays the same; however, the partnership would now like to make a Section 444 election to change its year-end. Is this permissible?

   a. Yes.

   b. No.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

2. Partnership A is owned by two partners, B, a foreign corporation that owns a 95-percent interest in the capital and profits of partnership A, and C, a domestic corporation that owns the remaining 5-percent interest in the capital and profits of partnership A. Partnership A is not engaged in the conduct of a trade or business within the United States, and, accordingly, partnership A does not earn any income that is effectively connected with a U.S. trade or business. B uses a March 31 fiscal year. Which of the following year-end dates must Partnership A adopt for federal tax purposes?

   a. January 1.

   b. March 31.

   c. April 15.

   d. December 31.

3. Partnership A is owned by two partners, B, a foreign corporation that owns a 95-percent interest in the capital and profits of partnership A, and C, a domestic corporation that owns the remaining 5-percent interest in the capital and profits of partnership A. Partnership A is not engaged in the conduct of a trade or business within the United States, and, accordingly, partnership A does not earn any income that is effectively connected with a U.S. trade or business. B uses a March 31 fiscal year. Which of the following rules apply?

   a. Minority interest rule.

   b. Majority interest rule.

   c. Principal partners rule.

   d. Least aggregate deferral of income rule.

4. If the majority interest rule does not apply, what percentage of either profits or capital interest must a partner own to be considered a principal partner?

   a. 3%.

   b. 5%.

   c. 10%.

   d. 15%.

5. Under Rev. Proc. 2006-46, how many months after a tax year change must a partnership wait before it can change its tax year again?

   a. 12 months.

   b. 24 months.

   c. 36 months.

   d. 48 months.

6. Which of the following statements regarding applying the nonconforming tax year rules is most accurate?

   a. A newly formed partnership that has made a previous Section 444 election can adopt a new nonconforming year if its required year changes.

   b. For a newly formed partnership to make a Section 444 election to use a nonconforming year, the deferral period must not be more than three months.

   c. A newly formed partnership can take advantage of the natural business exception if it files a Section 444 election.

   d. Most business situations, such as hiring patterns, will be accepted as a reason for a partnership to have a nonconforming year-end under the business purpose exception.

7. Which of the following types of partnerships can make a backup Section 444 election?

   a. Existing partnerships using their required year that have never made a Section 444 election.

   b. New partnerships attempting to obtain approval of a nonconforming tax year under the natural business year exception.

   c. New partnerships attempting to obtain approval of a nonconforming tax year on the basis of a business purpose.

   d. A partnership that requests automatic approval under Rev. Proc. 2006-46 to change its tax year.

8. Which of the following describes the downstream de minimis rule for a member of a tiered partnership?

   a. Ownership of a partnership by an S corporation, a partnership, trust, or a personal service corporation (PSC) is disregarded if they cumulatively own 5% or less of the owned partnership.

   b. Ownership of a partnership by an S corporation, a partnership, trust, or a PSC is disregarded if the cumulative income of all the organizations is less than 2% of gross income or less than 5% of adjusted taxable income of the partnership owning the interest.

   c. If a tiered structure consists only of S corporations, partnerships, or both, and if all the component members have the same tax year, a nonconforming tax year will be permitted.

   d. Do not select this answer choice.

Lesson 2: Accounting Methods

INTRODUCTION

No single accounting method is required of all businesses. Businesses, including partnerships, must use a system that clearly reflects income and expense and must maintain books and records allowing it to file a correct return based on that method. An accounting method clearly reflects income if all items of gross income and all expenses are treated consistently from year to year. In conjunction with the overall use of an accounting method, there are special accounting methods for long-term contracts, installment sales, and like-kind exchanges.

A partnership selects its overall accounting method when it files its first tax return. Depreciation, inventory, and other special accounting methods are selected in the year those items first impact the tax return. Once selected, an accounting method must be maintained until the partnership elects to change (with IRS permission, if necessary) or is required to change the method.

Generally, the following accounting methods are available to partnerships:

1. The cash method is used by many small partnerships with no inventories. Income is reported in the year cash or property is actually or constructively received, and expenses are deducted in the year cash or property is actually paid or transferred. However, any expenditure that creates an asset having a useful life extending substantially beyond the close of the tax year may have to be capitalized as a deferred asset.

2. The accrual method is intended to match income and expenses in the correct year and is used by most large partnerships. If inventories are necessary to account for income, the accrual method must be used to account for purchases and sales of inventories unless one of the exceptions discussed later in this lesson applies. Income generally is reported in the year earned, and expenses are deducted or capitalized in the year incurred.

3. A hybrid method is a combination of the cash, accrual, or other special accounting method that clearly reflects income and is used consistently. For example, an optician may offer diagnosis, prescription, and fitting services and sell lenses, frames, and contacts as well. The service part of the business may be allowed to use the cash method while the retail side must keep inventories and use the accrual method.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine the limitations on use of the cash method of accounting.
- Elect the accrual method and identify requirements to change from the cash to the accrual method of accounting.
- Identify the IRS requirements to change depreciation methods and correct errors.

Limitations on Use of the Cash Method

Under the cash method of accounting, income is reported in the year cash or property is actually or constructively received. Likewise, expenses are generally deductible in the year cash or property is actually paid or transferred. A taxpayer's use of the cash method and treatment of particular items of income and expense are both subject to the general rule that income must be "clearly reflected." This means that an expenditure creating "an asset having a useful life which extends substantially beyond the close of the taxable year" may not be deductible or may be deductible only in part when payment is made. The election to use the cash method is made by computing taxable income using the cash method in the initial year return. No election statement is required; however, the "Cash" box should be checked on line H of Form 1065.

If properly elected, a partnership can use the cash method unless it (1) is a tax shelter (in which case the accrual method must be used) or (2) has a C corporation partner (in which case the small partnership exception may still permit the use of the cash method). These same limitations apply to LLCs classified as partnerships for federal income tax purposes. IRC Sec. 448(b) provides an exception allowing use of the cash method of accounting by farming businesses.

A partnership that is otherwise allowed to use the cash method of accounting can do so without regard to the accounting methods used by its partners. For instance, a newly formed partnership made up of several corporations and/or sole-proprietorships using both the cash and accrual basis can adopt the cash method and report the income received from each of the businesses using the cash method. Election of the tax treatment of various partnership items, including the choice of accounting method, is made at the partnership level rather than at the partner level. The IRS has attempted to prevent the election of the cash method by a partnership that has accrual method partners. The Tax Court, however, overruled the IRS and permitted the use of the cash method by a partnership even though a tax advantageous deferral of income may result.

The same limitations that apply to partnerships for using the cash method of accounting also apply to LLCs. The IRS has made several rulings on whether an LLC can use the cash method of accounting. These rulings are interpretations of how IRC Sec. 448 is applied to LLCs taxed as partnerships. Generally, IRC Sec. 448 prohibits the use of the cash method by C corporations, partnerships with C corporation partners, or tax shelters. In some situations, an LLC may run afoul of the tax shelter definition because it is classified as a syndicate. An LLC is a syndicate if it allocates more than 35% of its losses to limited entrepreneurs.

The IRS has consistently found LLCs are not syndicates when all members engage in the LLC's profession (for example, the practice of law or accounting) and participate in its management. Even when an LLC's management is vested in members in varying degrees (i.e., use of an executive or management committee), the IRS ruled the LLC was not a syndicate. In addition, the IRS determined an LLC, when converted from a partnership, was not a syndicate if the partnership always reported taxable income, and the LLC does not expect to have losses. Even when the LLC had nonequity members (profits interest only), an LLC was not a syndicate if less than 35% of LLC losses would be allocated to the nonequity members.

Despite the favorable rulings, a blanket assumption that all LLCs can use the cash method of accounting is not appropriate, particularly when the LLC expects to generate tax losses. Also, although there is guidance on service-related LLCs, there is uncertainty whether an LLC in a nonservice business can use the cash method. It is also uncertain whether an LLC with more than 35% of its losses allocated to nonparticipatory members qualifies to use the cash method. An LLC falling into one of these categories may want to consider requesting a private letter ruling on its specific situation.

Tax Shelter Limitation

For cash method purposes, a tax shelter is (1) an enterprise (other than a C corporation) whose interests have been offered for sale in an offering required to be registered with a state or federal securities agency, (2) a syndicate, or (3) a tax shelter under IRC Sec. 6662(d)(2)(C)—i.e., an entity formed to avoid or evade federal income tax.

An entity is a tax shelter if, at any time, interests have been offered for sale in any offering required to be registered with any federal or state agency that regulates the offering of securities. State securities laws can present a problem, since it generally is harder to avoid requirements in the state of formation or operation. When the entity has passive investors and resembles a limited partnership, state registration may be required. In that event, the entity is treated as an *enterprise* and cannot use the cash method.

A syndicate is an entity (other than a C corporation) that allocates more than 35% of its losses during the tax year to limited partners or limited entrepreneurs. A limited entrepreneur is a person who has an interest in an enterprise other than as a limited partner and does not actively participate in management of the enterprise. Losses must be allocated during a year to run afoul of the "syndicate" provisions. Consequently, even if the owners are limited entrepreneurs, a syndicate does not exist until a year that losses are actually allocated.

Generally, a partnership with a C corporation partner cannot use the cash method. A *C corporation* does not include S corporations and personal service corporations (PSCs). A PSC is any corporation meeting the *function test* and the *ownership test*. The function test requires employees of the corporation to spend 95% or more of their time performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. The ownership test requires at least 95% of the stock value to be held by employees or retired employees who perform or performed services for the corporation. So, this requirement is failed if a spouse or child receives an interest in the corporation.

If the partnership has less than $5 million in annual gross receipts, the presence of a C corporation partner does not prevent it from using the cash method. To use this exception, the partnership's annual gross receipts cannot exceed $5 million for all prior tax years beginning after 12/31/85. To make this determination, the partnership looks back to each three-year period ending with such prior year and computes an average of the annual gross receipts. If the average does not exceed $5 million, the test is met for the prior year. If the partnership has not existed for three years, the test period includes the number of years it has existed. Gross receipts for short tax years must be annualized before making the computation.

Qualifying under Rev. Proc. 2001-10

In Rev. Proc. 2001-10, the IRS announced that small businesses with average gross receipts of $1 million or less for each prior tax year ending after 12/16/98 can use the cash method of accounting even if the business would otherwise be required to use the accrual method of accounting due to the presence of inventories. Rev. Proc. 2001-10 provides relief for many small businesses that may otherwise be vulnerable to the inventory issue. Equally important, it provides amnesty for small businesses that have used the cash method and failed to properly account for inventories in prior tax years, provided the taxpayer met the gross receipts test for the prior tax years.

To satisfy the gross receipts test of this relief provision, the average annual gross receipts of a partnership must be no more than $1 million. A three-year average is computed for each year based on the three-year period ending with the prior year. Once the three-year average for a tax year exceeds $1 million, the partnership will fail the gross receipts test beginning with the following tax year and will need to change to the accrual method of accounting. If a partnership has not been in business for the three-year period, the test is made using the number of years it has been in business. All businesses under common control must be aggregated when performing the gross receipts test. Finally, any short years must be annualized to determine whether the test has been met.

Example 2A-1 Applying the small business exception to use the cash method of accounting.

Ma & Pa Partnership (M&P) operates a small grocery store. The gross receipts for M&P are as follows: $870,000 for 2007, $950,000 for 2008, and $995,000 for 2009. Average gross receipts for this three-year period are $925,000 [($870,000 + $950,000 + $995,000)/3].

Therefore, M&P can use the cash method for 2010, even though the partnership technically would be required to use the accrual method of accounting because of the grocery inventory.

Qualifying under Rev. Proc. 2002-28

Partnerships with average annual gross receipts above $1 million may be able to take advantage of the provisions in Rev. Proc. 2002-28 to use the cash method. This procedure allows qualifying small businesses with average annual gross receipts between $1 million and $10 million for each prior tax year ending on or after December 31, 2000, to use the cash method with respect to eligible trades or businesses. A partnership has average annual gross receipts of $10 million or less if its average annual gross receipts for the three tax-year period do not exceed $10 million. If a partnership has not been in existence for three prior tax years, it must determine its average annual gross receipts for the number of years it has been in existence (including short tax years). In determining if the gross receipts test is met, gross receipts for a tax year is defined as all receipts that must be recognized under the method of accounting actually used by the taxpayer for that tax year for federal income tax purposes. Once average annual gross receipts exceed $10 million, the entity will need to change to the accrual method.

A qualifying small business is any taxpayer meeting the average annual gross receipts test that is not prohibited from using the cash method under IRC Sec. 448 (i.e., partnerships with C corporation partners if their average annual gross receipts exceed $5 million, or partnerships classified as tax shelters). A qualifying small business is not an eligible trade or business if its principal business activity is a mining activity described in North American Industry Classification System (NAICS) codes 211 or 212, a wholesale trade described in NAICS code 42, a manufacturing business described in NAICS codes 31-33, a retail trade described in NAICS codes 44-45, or an information industry described in NAICS codes 5111 and 5122. An otherwise qualifying partnership with a prohibited business activity can still use the cash method if its principal business activity is the provision of services (including property incident to those services) or is the fabrication or modification of tangible personal property upon demand in accordance with customer design or specifications.

Practitioners can determine the NAICS code for a partnership by going to **www.census.gov**, and then clicking on "N" under "Subjects A to Z." Some of the industries that may benefit from Rev. Proc. 2002-28 include construction, transportation, warehousing, health care, finance and insurance, entertainment and recreation, lodging, professional and technical services, food services, repair and maintenance, and personal services.

Changing to the Cash Method

New partnerships that meet the tests previously discussed can take advantage of Rev. Proc. 2001-10 or Rev. Proc. 2002-28 simply by using the cash method—special notification to the IRS is not required. Existing accrual method partnerships that satisfy these eligibility tests receive automatic consent to change to the cash method if the procedures of Rev. Proc. 2008-52 are followed. In general, the taxpayer attaches Form 3115 (Application for Change in Accounting Method) to the return for the year of change, labeled "Filed under Rev. Proc. 2001-10" or "Filed under Rev. Proc. 2002-28," as appropriate.

The adjustment to convert from the accrual to the cash method [the Section 481(a) adjustment] will generally be a negative amount, and if so the deduction is claimed in the year of change. If the adjustment is positive, it may be spread equally over four years, or electively reported in one year if the net change is under $25,000. In general, the Section 481(a) adjustment is calculated by reversing accrual items reflected in the opening balance sheet. This will include the reversal of accounts receivable and accounts payable.

Handling Cost of Materials under Cash Method

Although the inventory accounting rules do not apply to partnerships using the cash method, merchandise on hand at the end of the year cannot be deducted as cost of sales. Instead, qualifying partnerships must treat merchandise inventory in the same manner as materials or supplies that are not incidental under Reg. 1.162-3. Under this regulation, partnerships can deduct only the cost of materials and supplies that are actually consumed and used in operations during the tax year. Under Rev. Procs. 2001-10 and 2002-28, there is no requirement to capitalize labor or other overhead or to apply the UNICAP rules to the materials inventory.

Accounting Methods for Partnerships with Inventories

Unless Rev. Proc. 2001-10 or Rev. Proc. 2002-28 applies, a partnership maintaining inventory must use the accrual method to account for purchases and sales. Additionally, partnerships with inventories (whether purchased, manufactured, or produced) may be required to capitalize certain costs under IRC Sec. 263A. Furthermore, certain partnerships engaged in farming (including partnerships allocating more than 35% of losses to limited partners) are precluded from deducting amounts paid for such items as seed, fertilizer, or other farm supplies until the year in which the supplies are actually used.

Choosing a Hybrid Accounting Method

Generally, partnerships not precluded from using the cash method can elect to use any other method, including a hybrid method. A hybrid method combines elements of two or more methods, such as cash and accrual. A hybrid method is a permissible accounting method if it clearly reflects income and is consistently used by the partnership. (The IRS has recently begun to use the "does not accurately reflect income" argument to force entities to change to the accrual method.) Unless required to use the accrual method, a partnership can elect to use the accrual method to account for purchases and sales, but use the cash method to account for any other element of income or expense. However, the same method used in computing gross profit must be used in computing the trade or business expenses associated with that gross profit. Each different trade or business of a partnership can elect a different method of accounting.

Partnerships Engaged in Farming Business

A farming enterprise, unless it meets the definition of a tax shelter, can use the cash method for its farming operations even though it cannot use the cash method for its other businesses. For this purpose, a farming enterprise includes growing or harvesting agricultural products; raising livestock or poultry; operating a nursery or sod farm; raising or harvesting fruit, nut, or ornamental trees; and raising timber.

Using the Nonaccrual Experience (NAE) Method

The nonaccrual experience (NAE) method of accounting is available only for amounts to be received for the performance of qualified services and for services provided by certain small businesses. Amounts to be received for all other services are subject to the general rule regarding inclusion in income. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged. A nonaccrual experience method is a hybrid accrual method where amounts received for the performance of services are not included in income, if based on experience, they will not be collected.

Under a special rule, the nonaccrual experience method of accounting is available for the performance of non-qualified services if the average annual gross receipts [as defined in IRC Sec. 448(c)] of the taxpayer (or any predecessor) do not exceed $5 million. The rules of paragraph (2) and (3) of IRC Sec. 448(c) (i.e., the aggregation of related taxpayers, taxpayers not in existence for the entire three year period, short tax years, definition of gross receipts, and treatment of predecessors) apply when computing the average annual gross receipts test.

Reg. 1.448-2 provides alternative computations or formulas to determine the uncollectible amounts and include safe harbor methods based on a taxpayer's experience. Taxpayers eligible to use the NAE method may use one of four safe harbor methods of accounting or an alternative method that meets certain requirements.

Rev. Proc. 2006-56 allows taxpayers to request the IRS's consent to make certain changes to, from, or within a NAE method of accounting, or to adopt certain NAE methods, effective for tax years ending on or after 8/31/06. This revenue procedure does not apply to taxpayers seeking to adopt one of the safe harbor NAE methods provided in Reg. 1.448-2(f)(1) through (f)(5). Instead the taxpayer must follow the general rules for adoption of a method of accounting in Reg. 1.446-1(e)(1).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. How does a partnership elect to use the cash method of accounting?

    a. Filing a special election statement along with the initial year return.

    b. By computing taxable income using the cash method in return for the initial year.

    c. The general rules for adopting a method of accounting under Reg. 1.1446-1(e)(1) must be used.

12. In which of the following situations, is a partnership unable to use the cash method of accounting?

    a. It is a tax shelter.

    b. It has an S corporation partner.

    c. It is an LLC.

    d. It is a farming business.

13. Which of the following statements is accurate regarding a tax shelter?

    a. For cash method purposes, a tax shelter is a C corporation with interests that have been offered for sale where the offering must be registered with a federal securities agency.

    b. For cash method purposes, a tax shelter is any entity formed with the purpose of avoiding federal income tax.

    c. A tax shelter is considered a syndicate with less than 20% of its losses allocated to limited partners.

    d. If an entity has passive investors and resembles a limited partnership, it will be a tax shelter.

14. Which partnership qualifies to use the cash method under Rev. Proc. 2002-28?

    a. The Buy More partnership has average gross receipts of $900,000 for the past three tax years.

    b. The Laredo partnership has average annual gross receipts of $5 million for the past three tax years.

    c. The Central partnership has average annual gross receipts of $11 million for the past three tax years.

    d. The Volume partnership maintains an inventory.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. How does a partnership elect to use the cash method of accounting? **(Page 157)**

    a. Filing a special election statement along with the initial year return. [This answer is incorrect. No election statement is required for a partnership taxpayer to use the cash method of accounting; though there is a place on Form 1065 where the taxpayer can indicate what accounting method was used. A special election is also not required for use of the accrual method of accounting.]

    b. By computing taxable income using the cash method in return for the initial year. [This answer is correct. The election to use the cash method is made by computing taxable income using the cash method in the initial year return and indicating in the proper place on the form that the cash method is being used. Form 1065 has a "Cash" box on line H that should be checked to indicate that the cash method was used to prepare the return.]

    c. The general rules for adopting a method of accounting under Reg. 1.1446-1(e)(1) must be used. [This answer is incorrect. This is true if a partnership seeks to adopt one of the safe harbor methods under the nonaccrual experience (NAE) method provided in Re. 1.448-2(f)(1) through (f)(5).]

12. In which of the following situations, is a partnership unable to use the cash method of accounting? **(Page 157)**

    a. It is a tax shelter. [This answer is correct. Under the general rule for use of the cash method of accounting, a partnership can, if properly elected, use the cash method, except in two situations. One of the situations when a partnership cannot use the cash method is if it is a tax shelter. Tax shelters must use the accrual method.]

    b. It has an S corporation partner. [This answer is incorrect. If a partnership has a C corporation partner, not an S corporation partner, generally it is ineligible to use the cash method of accounting.]

    c. It is an LLC. [This answer is incorrect. The same two limitations that apply to partnerships using the cash method also apply to LLCs that are classified as partnerships for federal income tax purposes. Being classified as an LLC is not one of the circumstances that makes a partnership ineligible to use the cash method.]

    d. It is a farming business. [This answer is incorrect. IRC Sec. 448(b) provides an exception allowing use of the cash method of accounting by farming businesses.]

13. Which of the following statements is accurate regarding a tax shelter? **(Page 158)**

    a. For cash method purposes, a tax shelter is a C corporation with interests that have been offered for sale where the offering must be registered with a federal securities agency. [This answer is incorrect. For cash method purposes, a tax shelter is an enterprise, *other than* a C corporation, whose interests have been offered for sale in an offering required to be registered with a state or federal securities agency.]

    b. For cash method purposes, a tax shelter is any entity formed with the purpose of avoiding federal income tax. [This answer is correct. Any tax shelter under IRC Sec. 6662(d)(2)(c), such as an entity formed to avoid or evade federal income tax, is considered a tax shelter for cash method purposes.]

    c. A tax shelter is considered a syndicate with less than 20% of its losses allocated to limited partners. [This answer is incorrect. For cash method purposes, a tax shelter can be a syndicate. A syndicate is an entity (other than a C corporation) that allocates more than 35% of its losses, not 20%, during the tax year to limited partners or limited entrepreneurs.]

    d. If an entity has passive investors and resembles a limited partnership, it will be a tax shelter. [This answer is incorrect. When the entity has passive investors and resembles a limited partnership, state registration may be required. In such cases, the entity is treated as an *enterprise* not a tax shelter and *cannot* use the cash method.]

14. Which partnership qualifies to use the cash method under Rev. Proc. 2002-28? **(Page 159)**

   a. The Buy More partnership has average gross receipts of $900,000 for the past three tax years. [This answer is incorrect. With these average gross receipts, Buy More qualifies to use the cash method under Rev. Proc. 2001-10, not Rev. Proc. 2002-28.]

   b. The Laredo partnership has average annual gross receipts of $5 million for the past three tax years. [This answer is correct. To qualify for use of the cash method with respect to eligible trades or business under Rev. Proc. 2002-28, a small business must have average annual gross receipts between $1 million and $10 million for each prior tax year ending on or after December 31, 2000. A partnership has average annual gross receipts of $10 million or less if its average annual gross receipts for the three-tax-year period do not exceed $10 million.]

   c. The Central partnership has average annual gross receipts of $11 million for the past three tax years. [This answer is incorrect. The average annual gross receipts for Central partnership are too high to qualify for use of the cash method under Rev. Proc. 2002-28. Central partnership must use the accrual method of accounting.]

   d. The Volume partnership maintains an inventory. [This answer is incorrect. Unless certain exceptions are met, a partnership maintaining inventory must use the accrual method to account for purchases and sales. Without knowledge of Volume's average annual gross receipts for the past three years, we must assume it should use the accrual method.]

The Accrual Method

Under the cash method, income is recorded in the year it is actually or constructively received, and expenses are deducted in the year they are actually paid. Partnerships using the accrual method report income when the right to receive the income has occurred and the amount can be determined with reasonable accuracy. Deductions under the accrual method are allowable in the year in which (1) all events necessary to establish the fact of liability or deduction have occurred, (2) the amount of the liability or deduction is determinable with reasonable accuracy, and (3) economic performance has occurred. Regulations on economic performance may cause practitioners to question whether there really is such a thing as the accrual method of accounting with respect to expenses.

Any partnership can elect to use the accrual method, although certain partnerships are *required* to use it. The election is made by computing and reporting the partnership's income for the initial year under accrual accounting principles. No election statement is required; however, the "Accrual" box should be checked on line H of Form 1065. Partnerships using the accrual method may still be prohibited from deducting certain expenses paid to related persons until the recipient reports the amount in income. This provision applies only if the payment is not includable in the recipient's income at the time the payor accrues it.

Example 2B-1 Payments to related cash-basis taxpayer.

The Yellow Partnership has properly elected the accrual method. At the close of its fiscal tax year on 9/30/10, the partnership accrues a $60,000 commission payable to the Green Corporation. Jim Green owns 100% of the Green Corporation and 60% of the Yellow Partnership's capital and profits. The Green Corporation uses the cash method. The partnership pays the commission on 10/15/10.

The partnership cannot deduct the commission until the day the corporation includes it in income. Since the corporation includes the commission in income on 10/15/10, the partnership obtains a deduction on that day. The partnership deducts the $60,000 commission payment in the year ending 9/30/11.

Handling Advance Trade Discounts

Advance trade discounts considered the equivalent of loans or security deposits are not gross income. Advance trade discounts are volume discounts received as cash in exchange for an obligation to buy a minimum quantity of goods. The buyer must repay the cash advance to the extent the volume commitment is not met. The 9th Circuit came to this conclusion in *Westpac Pacific Food* and characterized the advances as liabilities rather than income. The IRS decided to follow the decision in *Westpac Pacific Food* and provided procedures for obtaining consent to change to the advance trade discount method in Rev. Proc. 2007-53. This change was incorporated into Rev. Proc. 2008-52 as automatic change number 111.

Electing to Defer Taxability of Advance Payments

Accrual basis taxpayers may elect to defer taxability of advance payments received in connection with services, and in some cases for nonservices, under Rev. Proc. 2004-34. For such taxpayers, who already receive advance payments that currently are being reported as received (but qualify for deferral), a Form 3115 (Change in Accounting Method) will be needed to switch to not accruing advance payments in the year received. Other taxpayers can simply use this method beginning with the first year they receive advance payments.

Rev. Proc. 2004-34 generally requires an accrual basis taxpayer using the deferral method to include advance payments in income the earlier of the tax year in which it is included in the taxpayer's applicable financial statement, or the tax year following the year of receipt. Advance payments qualifying for deferral include:

1. Services.
2. The sale of goods [unless the taxpayer uses a deferral method under Reg. 1.451-5(b)(1)(ii)].
3. Intellectual property (including copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights such as franchise rights and arena naming rights).

4. The occupancy or use of property if ancillary to the provision of services (such as a hotel room, booth space at a trade show, or campsite space at a mobile home park).

5. The sale, lease, or license of computer software.

6. Guaranty or warranty contracts ancillary to the items described in items 1.–5.

7. Online and tangible subscriptions (unless Section 455 prepaid subscription income provisions apply).

8. Memberships in an organization (unless Section 456 prepaid membership dues provisions apply).

9. Any combination of the items described in items 1.–8.

Advance payments are eligible for deferral only if they are includable in gross income for the year of receipt under the taxpayer's permissible method of accounting and the payments are recognized (in whole or in part) in revenues in its applicable financial statement for a subsequent tax year (or, for taxpayers without an applicable financial statement, the payment is earned by the taxpayer in whole or in part in a subsequent tax year). An applicable financial statement is a financial statement required to be filed with the SEC; a certified audited financial statement used for credit purposes, reporting to shareholders, or any other substantial nontax purpose; or a financial statement (other than a tax return) required to be provided to the federal or state government or agency.

Rev. Proc. 2004-34 bases the deferral on the treatment used in the taxpayer's applicable financial statement. Taxpayers that cannot determine the treatment of an item included in their applicable financial statement and those that do not have such a statement can still defer advance payments. The following methodologies can be used to determine the amount of income to recognize:

1. On a statistical basis if adequate data is available.

2. On a straight-line ratable basis over the term of the agreement if the advance payments are received under a fixed term agreement and it is not unreasonable to expect at the end of the year of receipt that the advance payment will be earned ratably over the term of the agreement.

3. Any other basis that results in a clear reflection of income.

Reporting Advance Payments for Services. Generally, advance payments for services to be performed in a later tax year must be reported in the year when payments are received. However, an accrual basis business may elect to defer income until it is earned if the payments are for services that will be performed by the end of the next tax year. No deferral is allowed beyond the tax year after the year in which the advance payments were received. Any prepayment reported in income for tax purposes must at least equal the amount reported on the business's applicable financial statements. Businesses wanting to change their method of accounting to defer advance payments must have IRS consent to do so.

Example 2B-2 Deferring prepaid income for dance lessons to be provided in the future.

On 11/2/10, a calendar-year, accrual method dance studio receives payment for a one-year contract for 48 one-hour lessons beginning on that date. Eight lessons are given in 2010. The dance studio recognizes one-sixth (8/48) of the payment in revenues for 2010, and five-sixths (40/48) of the payment in revenues for 2011 in its applicable financial statements. The dance studio must include one-sixth of the payment in income for 2010, and five-sixths of the payment in 2011.

Variation: Assume the same facts except the payment is for a two-year contract for 96 one-hour lessons. The dance studio provides 8 lessons in 2010, 48 lessons in 2011, and 40 lessons in 2012. The dance studio recognizes one-twelfth (8/96) of the payment in revenues for 2010, six-twelfths (48/96) of the payment in revenues for 2011, and five-twelfths (40/96) of the payment in revenues for 2012 in its applicable financial statements. However, the dance studio must include one-twelfth of the payment in gross income for 2010, and the remaining eleven-twelfths of the payment in gross income for 2011.

Reporting Advance Payments for Service Agreements. Advance payments received for service agreements are generally reported in the year the payments are received. However, an accrual basis business that receives advance payments for service agreements on property that it sells, leases, builds, installs, or constructs can elect to postpone including prepayments in income until earned, if, in its applicable financial statements, the business recognizes income as it is earned.

Example 2B-3 Deferring income under a prepaid service agreement.

Ace Partnership manufactures, sells, and services computers. Payment is received in 2010 for a one-year contingent service contract on a computer sold by Ace. Income can be postponed for the part of the payment not earned in 2010 if, in its applicable financial statements, Ace recognizes revenue in the same amount.

Reporting Prepaid Inventory Sales. Generally, prepaid inventory sales are reported in the year payment is received if the income is subject to the business's free and unrestricted use. However, a business can elect an alternative method to report prepaid inventory sales in the earlier of the year in which the payment would be reported (1) for income tax accounting purposes, or (2) for financial accounting reports.

A business electing the alternative method may be subject to a special rule for certain agreements involving sales of goods properly includable in its year-end inventory, or agreements such as gift certificates that can be satisfied with goods or a type of goods that cannot be identified in the year of sale. The company may postpone reporting advance payments for these inventory sales until no later than the end of the second tax year following the end of the tax year in which *substantial advance payments* are received. Alternatively, the business can elect to use the provisions of Rev. Proc. 2004-34 to defer recognition of advance payments for the sale of merchandise.

Example 2B-4 Deferring prepaid inventory sales.

Dollar Off, a discount retailer, receives advance payments for gift cards that may later be redeemed for products at the store. The gift cards expire 12 months from the date of sale, and Dollar Off does not accept expired cards. Dollar Off recognizes unredeemed gift card revenues in its applicable financial statements for the year in which the cards expire. Because Dollar Off is able to determine the extent to which advance payments are recognized in revenues for the tax year of receipt, it may elect under Rev. Proc. 2004-34 to defer including the advance payments in income.

Reporting Advance Payments for Warranty Contracts. Advance payments under guaranty or warranty contracts generally must be reported when received. However, an accrual-method retailer of motor vehicles or other durable consumer goods can elect to defer some of the advance payments until later years. To qualify, the taxpayer must sell multiyear service warranty contracts separately on those items and must have purchased insurance from an unrelated third party to insure its obligation.

If a business is not using an accounting method provided in Rev. Proc. 97-38 for payments on service warranty contracts, it might elect to defer those advance payments using the deferral method provided in Rev. Proc. 2004-34. However, payments received by a taxpayer for warranty and guaranty contracts under which a third party (such as a manufacturer) is the primary obligor are excluded from the deferral method under Rev. Proc. 2004-34.

Reporting Prepaid Rent or Prepaid Interest. Generally, prepayments of rent or interest must be reported when received. Rev. Proc. 2004-34 excludes advance payments of rent (with a few exceptions, such as advance payments received for use of a banquet facility) and interest from the deferral method. Taxpayers that receive advance payments for goods and qualify to use the deferral method in Reg. 1.451-5 may use that method, including the rule for cost of goods sold (COGS) included in the regulation. Taxpayers that use the deferral method provided in Rev. Proc. 2004-34 must use the general rules under IRC Sec. 461 and the regulations for determining when a liability (including COGS) is incurred.

Understanding the Economic Performance Rules

Under IRC Sec. 461, the requirements for deducting an expense for an accrual-basis taxpayer are satisfied by fulfilling *all* of the following tests:

1. All events determining the liability have occurred.

2. The amount of the liability can be determined with reasonable accuracy.

3. Economic performance has occurred under IRC Sec. 461(h). However, the general economic performance rules do not override other Code Sections that specifically prescribe the timing of deductions for certain items (such as the Section 267 related party rules).

Generally, economic performance occurs when property or services are provided to (or by) a third party. If the liability relates to the use of property (e.g., rental charges), economic performance occurs as the property is used. However, if the recurring item exception applies, the deduction can be taken before economic performance occurs—when the liability is fixed and the amount can be determined.

Example 2B-5 Economic performance rules.

A calendar-year partnership and a cleaning service company enter into a year-end agreement whereby the cleaning company will provide six months' maintenance of the partnership's property for $10,000. The services are to begin at the start of the following year. The contract sets forth the liability amount and constitutes a binding obligation under the appropriate state law.

Since the economic performance rules have not been met by year-end, the liability cannot be deducted. However, under the recurring item exception, a deduction may be allowed as discussed later in this lesson.

Applying the Three and a Half-month Safe Harbor Rule

The economic performance regulations provide several safe harbors. One involves the determination of when services or property are treated as provided to a taxpayer. Under this safe harbor, economic performance is deemed to occur when payment is made for the property or services if they are reasonably expected to actually be provided within 3½ months of the payment. Thus, at the time of payment, an accrual-basis taxpayer can take a deduction or add a property cost to basis as long as the taxpayer reasonably expects the services or property will be provided by the other person within 3½ months. Otherwise, economic performance occurs in the tax year the services or property are actually provided.

Making Payments in Order for Certain Expenses to Be Deducted

In line with the government's goal to defer deductions, the regulations outline certain types of liabilities that require payment for economic performance to occur. This *payment-equals-performance* rule affects the following liabilities:

1. Liabilities arising out of any workers compensation act, tort, breach of contract, or violation of law claims.

2. Rebates and refunds.

3. Awards, prizes, and jackpots.

4. Liabilities for insurance, warranty, and service contracts.

5. Taxes (other than foreign taxes eligible for the foreign tax credit).

6. Other liabilities not specifically addressed elsewhere in the economic performance regulations or statute. For example, if the *other liability* relates to services or property provided to the taxpayer, the 3½-month rule explained above would apply, and the *payment-equals-performance* rule would not apply.

With regard to taxes, *payment* includes estimated payments and payments where the taxpayer later files a claim for credit or refund. It is not necessary to file state tax returns to achieve economic performance for state taxes paid during the year. Furthermore, accrual-basis taxpayers cannot deduct property taxes until they are paid, unless a Section 461(c) ratable accrual election has been made or the recurring item exception applies.

Understanding When a Payment Is Considered Made

In determining economic performance, the issue of when payment is made is critical. Under the economic performance regulations, time of payment is measured under the principles of the cash method of accounting. This means *payment* through the issuance of a note or other indebtedness is not payment for purposes of these rules.

Although the regulations generally require the payment be made to the person owed the liability, special circumstances may permit the deduction when payment is made to a third party. In general, a payment to a trust, escrow account, fund, or other third-party payee does not constitute economic performance. However, payments to designated settlement funds (under IRC Sec. 468B) and the assumption of an ongoing business's liabilities when the business is sold may qualify under these rules.

Recurring Item Exception to Economic Performance Rules

The recurring item exception allows a taxpayer using the accrual method to elect to treat certain recurring liabilities as being incurred during the current year if the all-events test is met even if economic performance has not occurred before the end of that year. Under this exception, an item can be taken into account in the year it becomes fixed and determinable if economic performance occurs on or before the earlier of:

1. the 15th day of the ninth calendar month following the close of the tax year, or

2. the date the partnership files a timely tax return for the year.

If economic performance occurs by the 15th day of the ninth calendar month following the close of the tax year but after the return has been filed, an amended return can be filed to deduct the item.

To qualify for this treatment, the recurring item must be better matched to income in the earlier year or it must be immaterial in amount. Generally, an item is immaterial if it is immaterial in absolute terms and in comparison with other items of income and expense, or it is immaterial for financial statement purposes. The matching standard is deemed to be met for rebates and refunds; awards, prizes, and jackpots; insurance, warranty, and service contracts; and taxes.

Changing from the Cash Method to the Accrual Method

A required change from the cash to the accrual method is deemed to be initiated by the taxpayer and made with the automatic consent of the IRS. A partnership required to change to the accrual method must attach Form 3115 (Application for Change in Accounting Method) to the return for the year of change.

Form 3115 must be filed no later than the due date, including extensions, of the taxpayer's income tax return for the year of change. A copy of Form 3115 must be filed with the IRS National Office no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change. The partnership must state, on an attachment to Form 3115, the period over which the Section 481(a) adjustment (to report the cumulative income or loss from the accounting method change) will be taken into account and the calculations and basis for reaching that conclusion. The Form 3115 must have the following statement printed or typed at the top of the first page: "AUTOMATIC CHANGE TO ACCRUAL METHOD—SECTION 448." If the partnership is requesting an identical change for more than one distinct trade or business, it may combine the request on one Form 3115 and attach a statement reflecting the businesses affected.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Under what accounting method is income reported when the right to receive the income has occurred and the amount can be determine with reasonable accuracy?

    a. Accrual.

    b. Cash.

16. If a partnership elects to use the deferral method for advance payments, when should it record advance payment for services?

    a. The earlier of the year in which the payment would be reported for financial accounting reports or income tax reporting purposes.

    b. When the services provided by the partnership concern advance payments of rent and interest.

    c. If the services will be performed by the end of the next tax year, income can be recorded when earned.

17. Which of the following would be affected by the government's *payment-equals-performance* rule?

    a. Foreign taxes that are eligible for the foreign tax credit.

    b. Advance payments for intellectual property.

    c. Liabilities for awards, jackpots, and prizes.

    d. Recurring items for which the expense is not material.

18. If a taxpayer is allowed a recurring item exception, an item can be taken into account in the year it becomes fixed and determinable if economic performance occurs. The date this must occur is on or before the earlier of the date the partnership files a timely tax return for the year, or:

    a. The 1st day of the sixth calendar month following the close of the tax year.

    b. The 15th day of the ninth calendar month following the close of the tax year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Under what accounting method is income reported when the right to receive the income has occurred and the amount can be determine with reasonable accuracy? **(Page 166)**

    a. **Accrual. [This answer is correct. Partnerships using the accrual method report income when the right to receive the income has occurred and the amount can be determined with reasonable accuracy. Deductions under the accrual method are allowable in the year in which (1) all events necessary to establish the fact of liability or deduction have occurred, (2) the amount of the liability or deduction is determinable with reasonable accuracy, and (3) economic performance has occurred. Regulations on economic performance may cause practitioners to question whether there really is such a thing as the accrual method of accounting with respect to expenses.]**

    b. Cash. [This answer is incorrect. Under the cash method, income is recorded in the year it is actually or constructively received, and expenses are deducted in the year they are actually paid.]

16. If a partnership elects to use the deferral method for advance payments, when should it record advance payment for services? **(Page 167)**

    a. The earlier of the year in which the payment would be reported for financial accounting reports or income tax reporting purposes. [This answer is incorrect. This is true for partnerships who want to use the deferral method to report prepaid inventory sales.]

    b. When the services provided by the partnership concern advance payments of rent and interest. [This answer is incorrect. Generally, prepayments of rent or interest must be reported when received. Rev. Proc. 2004-34 excludes advance payments of rent (with a few exceptions) and interest from the deferral method.]

    c. **If the services will be performed by the end of the next tax year, income can be recorded when earned. [This answer is correct. Generally, advance payments for services to be performed in a later tax year must be reported in the year when payments are received. However, an accrual basis business may elect to defer income until it is earned if payments are for services that will be performed by the end of the next tax year. No deferral is allowed beyond the tax year after the year in which the advance payments were received.]**

17. Which of the following would be affected by the government's payment-equals-performance rule? **(Page 169)**

    a. Foreign taxes that are eligible for the foreign tax credit. [This answer is incorrect. Liabilities for taxes are affected by the *payment-equals-performance* rule; however, the exception to this rule is foreign taxes eligible for the foreign tax credit.]

    b. Advance payments for intellectual property. [This answer is incorrect. Advance payments for intellectual property (including copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights, such as franchise rights and arena naming rights) are one type of advance payments that qualify for deferral.]

    c. **Liabilities for awards, jackpots, and prizes. [This answer is correct. In line with the government's goal to defer deductions, the regulations outline certain types of liabilities that require payment for economic performance to occur. Examples of liabilities affected by this rule include those arising out of any workers compensation act, tort, breach of contract, or violation of law claims; those for rebates and refunds; those for awards, prizes, and jackpots; and those for insurance, warranty, and service contracts.]**

    d. Recurring items for which the expense is not material. [This answer is incorrect. Recurring items are not affected by the *payment-equals-performance* rule. One of the conditions that must be met for expenses that are recurring in nature to be deducted is that it is either not material or if accrual of the expense results in better matching of the expense with related income.]

18. If a taxpayer is allowed a recurring item exception, an item can be taken into account in the year it becomes fixed and determinable if economic performance occurs. The date this must occur is on or before the earlier of the date the partnership files a timely tax return for the year, or: **(Page 170)**

    a. The 1st day of the sixth calendar month following the close of the tax year. [This answer is incorrect. Under the recurring item exception, an item can be taken into account in the year it becomes fixed and determinable if economic performance occurs on or before the earlier of 1) the date the partnership files a timely tax return for the year or, a date that is later in the year than the 1st day of the sixth calendar month following the close of the tax year.]

    b. The 15th day of the ninth calendar month following the close of the tax year. [This answer is correct. Under the recurring item exception, an item can be taken into account in the year it becomes fixed and determinable if economic performance occurs on or before the earlier of 1) the date the partnership files a timely tax return for the year, or 2) the 15th day of the ninth calendar month following the close of the tax year.]

Accounting Method Changes

A partnership generally must obtain IRS permission to change an accounting method. This is true even if the change is from an unacceptable (i.e., incorrect) method to an acceptable method. An accounting method change includes not only a change in the overall method used (e.g., cash or accrual), but any change in the tax treatment of a material item. Thus, changes in accounting method could include a change in the method of valuing inventory; a change from a long-term contract method (whether percentage-of-completion or completed-contract) to the cash or accrual method or vice versa; or the adoption, discontinuance, or use of any other specialized tax accounting method.

Any change not involving the timing of income or expense recognition is not an accounting method change. Determinations that accounting estimates were inaccurate do not involve an accounting method change—nor do situations where a factual or mathematical error occurs and is discovered after filing a return. IRS permission is not required to correct inaccurate estimates or errors.

Example 2D-1 Discovery of previous error.

DUH Partnership finds $50,000 of personal expenses have been accidentally deducted as business expenses. No change in accounting method is required since an error has occurred. Consequently, the partnership cannot spread the adjustment over several years. No IRS approval is required to correct the error.

The IRS has also ruled in TAM 199928001 that an adjustment to reflect an earlier change required by the IRS to the proper recovery period for an asset is not a change in accounting method.

Requesting an Accounting Method Change

IRS approval is requested by filing Form 3115 (Application For Change In Accounting Method) anytime during the year of change. Taxpayers no longer need to file accounting method change requests within the first 180 days of the tax year. The year of change for all taxpayer initiated changes generally is the tax year in which Form 3115 is filed. The IRS will allow taxpayers, under certain circumstances, to revise the year of change for a Form 3115 pending in the National Office rather than filing a new Form 3115. Form 3115 should be filed as early as possible during the year of change to give the IRS adequate time to respond to the Form 3115 prior to the original due date of the taxpayer's return for the year of change. This also will prevent the need to file an amended return if the change is approved after the original return has been filed. If the tax year is a short period, the Form 3115 should be filed no later than the last day of the short tax year.

Form 3115 must be accompanied by the required user fee. However, a domestic partnership can qualify for a reduced fee if its gross income is less than $1 million, and certain accounting method changes not requiring IRS approval (automatic changes) do not require a user fee.

Qualifying For a Six-month or 12-month Extension

An automatic 12-month extension is allowed for certain elections whose deadlines are prescribed by the regulations or other administrative pronouncements. The extension runs from the due date of the election, and the taxpayer must take corrective action within the 12-month period. If the election is required to be made by the due date of the return including extensions, the due date for making a regulatory election is the due date of the return including extensions. Corrective action requires either (1) filing an original or amended return with the required election form or statement or (2) taking whatever steps are required to file an election not made with a return. In addition, the taxpayer must report income in a manner consistent with the election for the year the election should have been made and subsequent years.

An automatic six-month extension is allowed for elections whose due date, as prescribed by the Code or regulations, is the due date, or the due date including extensions, of the return. The return must be timely filed (not extended) and corrective action must be taken within six months of the due date of the return excluding extensions. This extension is not available when the statute or regulations specifically provide the election must be made by the due date of the return excluding extensions. Corrective action requires filing an amended return to perfect the election. In addition, the taxpayer must report income on the election consistently with the year the election should have been made and subsequent years.

Any return filed to obtain either a six-month or 12-month automatic extension must say "FILED PURSUANT TO REG. 301.9100-2" at the top. These are filed with the IRS at the same location for filing a timely election. No private letter ruling is required and thus no user fee applies.

Knowing When Nonautomatic Extensions Are Available

Under Rev. Proc. 97-27, limited relief is available for late applications that are not eligible for one of the automatic extensions only when the taxpayer can show that there were "unusual and compelling circumstances" for missing the filing deadline. To obtain relief the partnership should request a letter ruling. The request must include signed affidavits from the taxpayer and other individuals having knowledge of the events surrounding the failure to file the election timely with the required user fee, which varies depending on the taxpayer and circumstances for the request.

Computing the Section 481(a) Adjustment

When a corporation changes accounting methods, adjustments must be made to ensure the change does not result in the omission or duplication of income or expense [IRC Sec. 481(a)]. These Section 481(a) adjustments can increase income (a positive adjustment) or decrease income (a negative adjustment).

Generally, positive Section 481(a) adjustments are taken into income over four years. However, this period is shortened (usually to one year) in the following instances:

a. De Minimis Rule. If a positive Section 481(a) adjustment is less than $25,000, the corporation may elect to use a one-year adjustment period.

b. Termination of Business. A corporation that ceases business operations must take the remaining balance of any Section 481(a) adjustment relating to those business operations into account in computing taxable income for the year of cessation.

c. Cut-off Method. Any change within the LIFO inventory method must be made using a cut-off method. Under a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the new method. Any items arising before the year of change continue to be accounted for under the old method of accounting.

Example 2D-2: Calculating a positive Section 481(a) adjustment.

Key Partnership uses the cash method of accounting, but is now changing to the accrual method. At the beginning of Year 1, Key has accounts receivable of $60,000 that have not been recognized as income. In addition it has $40,000 of accounts payable that have not been expensed. If Key simply changed to the accrual method in Year 1, this income and these expenses would never be reported for tax purposes.

Therefore, Key has a positive Section 481(a) adjustment of $20,000 ($60,000 accounts receivable less $40,000 accounts payable) that it must include in income. Since the adjustment is less than $25,000, Key can elect to use a one-year adjustment period, or it can recognize the income over a four-year period per the general rule.

The adjustment will be reported on Line 7—Other Income on Form 1065. A separate statement should be attached showing the Section 481(a) adjustment calculation. This adjustment may also need to be reported on Schedule M-1 on page 4 of the Form 1065 as a book-tax difference. If the partnership is required to file Schedule M-3, this adjustment may need to be reported on page 2, Part II, Line 17.

Handling Negative Adjustments. Negative Section 481(a) adjustments are deducted in full in the year of the change in accounting method.

Utilizing the Automatic Change Revenue Procedures

Some changes do not require IRS consent. Such changes are either automatically approved or presumed to be made with the IRS's consent. A list of the automatic change revenue procedures can be found in Rev. Proc. 2010-1, section 9.22. These procedures generally provide simplified uniform guidance, terms, and conditions to obtain automatic consent to make those changes.

Rev. Proc. 2008-52 clarifies that the automatic extension of six months from the due date of the return provided in Reg. 301.9100-2 is applicable to automatic changes made in accordance with this revenue procedure. The extension is available if the taxpayer has timely filed its tax return and files an amended return with the six-month extension period consistent with the new method of accounting. In addition, the taxpayer must attach the original application to the amended return. A copy of the application must also be filed with the National Office marked "FILED PURSUANT TO REG. 301.9100-2."

No user fee is required for applications filed under Rev. Proc. 2008-52, and the IRS will not acknowledge the receipt of an application. The taxpayer must file a Form 3115 in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change. A copy of Form 3115 must be filed with the IRS National Office no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change.

According to Rev. Proc. 2008-52, the taxpayer must type or clearly print the designated automatic accounting method change number for the requested change of accounting method on the application. When the requested change is made using Form 3115, the taxpayer must enter the designated automatic accounting method change number for the requested change on the appropriate line on the Form 3115. These numbers are listed in the instructions to Form 3115. For example, a taxpayer requesting a change from the cash to the accrual method of accounting must enter the number "123" on Line 1(a) of Form 3115.

If the instructions in the appendix indicate that a statement should be filed instead of Form 3115, the taxpayer's name and employer identification number must be included at the top of the first page of the statement under any other required label. In addition, the taxpayer must enter the designated automatic accounting method change number for the requested change at the top of the first page of the statement, directly above the taxpayer's name and employer identification number (EIN).

In general, a taxpayer may enter only one designated automatic accounting method change number on an application. But where this revenue procedure or other guidance published in an Internal Revenue Bulletin specifically permit two or more particular changes in accounting method to be made on a single application, a taxpayer must enter the designated automatic change number for each change requested on the application.

The IRS issued Rev. Proc. 2009-39, which clarifies and modifies Rev. Proc. 2008-52 (changes that receive automatic consent) and Rev. Proc. 97-27 (taxpayer-initiated changes that do not receive automatic consent). Subject to certain transition rules, Rev. Proc. 2009-39 is effective for applications filed under Rev. Proc. 97-27 or Rev. Proc. 2008-52 on or after 8/27/09 for a year of change ending on or after 12/31/08. Rev. Proc. 2009-39 revises Rev. Proc. 2008-52 in several ways, including (1) the computation of the Section 481(a) adjustment in order to take into account all relevant accounts; and (2) the addition of new sections to the Appendix of Rev. Proc. 2008-52 for specific changes, including (among others) changes involving materials and supplies, repair and maintenance costs, and real property taxes.

Involuntary Accounting Method Changes

Rev. Proc. 2002-18 requires the IRS and the taxpayer to treat all involuntary accounting method adjustments made at the exam level as a change in accounting method. The taxpayer must continue using the current method of accounting unless advance consent under the voluntary accounting method change procedures are obtained. Rev. Proc. 2002-18 provides flexibility for examining agents to compromise terms and conditions; however, it does not permit an examining agent to allow a Section 481(a) adjustment to be spread over a period of years.

Proposed Changes to Process for Obtaining Accounting Method Change

The IRS is concerned that the existing process is complex and inefficient for taxpayers and recently requested comments on a proposal to change the process. Under the proposal, taxpayers would request a standard consent, specific consent, or letter ruling consent. Most change requests would be made through the standard consent process, which would operate much like the current automatic consent process (i.e., a taxpayer timely filing Form 3115 and complying with the appropriate procedures would be granted consent). The specific consent process would be available for (1) accounting method changes identified in published guidance that have to be made under the specific consent process, and (2) changes that would qualify under the standard consent process except that the taxpayer seeks different terms and conditions or a waiver of certain scope limitations. A taxpayer utilizing the letter ruling consent process (e.g., to obtain the certainty of a letter ruling issued by the National Office) would have to submit a fully developed request meeting the same standards of factual and legal development as other letter ruling requests.

The IRS will evaluate the comments on the proposal before establishing a pilot program in separate guidance. In the meantime, taxpayers must continue to follow the existing procedures. To date, no such guidance has been issued.

Erroneous Methods of Accounting

Rev. Rul. 90-38 holds that a taxpayer cannot, without the IRS's consent, retroactively change from an erroneous to a permissible accounting method by filing an amended return (even if the statutory period for amending the return for the first year in which the erroneous method was used has not expired). Instead, a taxpayer can only change a method of accounting with the consent of the IRS and the change must be prospective, not retroactive. Generally, consent is obtained by filing Form 3115 (Application for Change in Accounting Method).

The same treatment of a material item in two or more consecutively filed tax returns represents "consistent treatment" of such item for purposes of Reg. 1.446-1(e). Consistent treatment means the taxpayer has established an accounting method that requires IRS consent to change. Consistent but erroneous treatment of material items also constitutes an accounting method. If a taxpayer's treatment of an item is an accounting method, IRC Sec. 446(e) precludes the taxpayer from making a retroactive change in accounting method without the IRS's consent.

Factual or mathematical errors discovered after a return has been filed do not involve a change of accounting method. IRS permission is not required to correct such errors.

The distinction between a change in method of accounting and the correction of a mathematical error can be significant because of IRC Sec. 481, which requires that adjustments be made in the year of change to prevent amounts from being duplicated or omitted. A change of accounting method adjustment may include amounts from previous years, even if the statute of limitations has expired for those years, while an adjustment to correct an error is limited to open tax years. In *Huffman*, the Section 481 adjustment corrected a multiyear mistake in the link-chain, dollar-value method of valuing LIFO inventory. The court said that the accountant "reached an erroneous result not because he made a mistake in arithmetic . . . but because he omitted the critical step of multiplication altogether."

Depreciation Deduction Corrections

Errors that cause the partnership to depreciate assets over too long a period, to use slower than allowable depreciation methods, or to use the wrong placed-in-service convention may mean the partnership failed to claim some depreciation to which it was entitled in earlier years.

If an understatement is not corrected, the effect is a permanent overstatement of taxable income because the tax basis of depreciable or amortizable property is reduced for computing gain or loss on disposition by the greater of depreciation or amortization allowed or allowable. In other words, basis is reduced by the full amount of depreciation or amortization that would have been claimed if a proper method had been used, regardless of whether the correct amount was actually claimed on the taxpayer's returns.

Regulations determine which changes in depreciation constitute changes in an accounting method.

Generally, to correct errors that are discovered, the business may file an amended return if the erroneous method has been used for less than two years. If the erroneous method has been used for two years or more, the IRS considers this to be an election of an accounting method. However, Rev. Proc. 2007-16 waives the rule in Rev. Rul. 90-38 that a taxpayer using an erroneous accounting method on two consecutive returns has established an accounting method. This allows taxpayers to change an erroneous depreciation method for assets for which depreciation has only been claimed for one tax year (i.e., assets placed in service during the year immediately preceding the year of change). Alternatively, taxpayers can correct depreciation on these assets by filing an amended return.

Rev. Proc. 2007-16 also provides relief from the "allowed or allowable" trap by allowing taxpayers to automatically change their accounting method for depreciation on certain disposed assets when they did not claim the full amount of depreciation allowable. Prior to this, a taxpayer who discovered such an error in a later year, or had a change proposed on an IRS audit, had no way of correcting the error made on previous years' returns.

Applying the Automatic Change Procedures

Rev. Proc. 2008-52 permits taxpayers to adjust for understated or overstated depreciation or amortization deductions from prior years by restating accumulated depreciation to the allowable amount and recovering the difference between the restated and actual accumulated depreciation using a Section 481 adjustment. Taxpayers requesting a change under the automatic change procedure must attach Form 3115 to a timely filed (including extensions) tax return for the year of change. A copy of Form 3115 must also be filed with the IRS National Office no earlier than the first day of the year of change (i.e., January 1 for calendar-year taxpayers) and no later than the due date (including extensions) of the taxpayer's return for the year of change. Filing under the automatic change procedures is usually preferable to filing a general request for an accounting method change due to the reduced costs (no user fee, etc.) and simplified procedures involved with the automatic change. The procedures for filing an automatic change in a method of accounting are contained in Rev. Proc. 2008-52.

Property Eligible for the Automatic Change Procedure

The automatic change procedure under Rev. Proc. 2008-52 generally applies to property subject to depreciation or amortization under IRC Secs. 167, 168 or 197 (or former IRC Sec. 168) for which the taxpayer claimed more or less than the allowable depreciation or amortization and which is held by the taxpayer as of the beginning of the year of change. This enables taxpayers to restate accumulated depreciation and amortization for all prior tax years.

Example 2F-1 Property eligible for automatic depreciation catch-up.

ABC Partnership is using seven-year MACRS to depreciate equipment purchased in 2007. In June 2010, ABC learns that the equipment should have been depreciated over five years under class 57.0, Distributive Trades and Services, because it is used in a wholesale business. ABC is also using seven-year MACRS to depreciate copiers purchased in 2007. In 2008, ABC learned that the copiers should have been depreciated using a five-year life; however, it decided at that time not to request a change in accounting method.

ABC can use the automatic change procedures in Rev. Proc. 2008-52 to catch up the depreciation shortfall on both the equipment and the copiers on its 2010 tax return. ABC should attach Form 3115 to its timely filed 2010 tax return and file a copy of Form 3115 with the IRS National Office no later than the due date (including extensions) of its 2010 tax return.

Property Not Eligible for the Automatic Change Procedure

The automatic change procedures for incorrect depreciation methods under Rev. Proc. 2002-9 and its successor Rev. Proc. 2008-52 generally do not apply to:

1. property for which the taxpayer is seeking to make or revoke (a) an election under IRC Secs. 167, 168, or former IRC Sec. 168 (e.g., election out of MACRS), or (b) an election to retroactively apply the Section 197 rules for amortization of intangibles;

2. intangible property amortized under IRC Sec. 167 [other than intangibles excluded from IRC Sec. 197 and amortized under IRC Sec. 167(f)];

3. property depreciated or amortized under IRC Sec. 167 [other than IRC Sec. 167(f)] for which the taxpayer is changing only the estimated useful life;

4. depreciable or amortizable property that changes use but continues to be owned by the same taxpayer;

5. accounting method changes from currently expensing the cost of property to capitalizing and depreciating or amortizing the cost;

6. changing from one permissible method of depreciation or amortization to another (e.g., from straight-line ADS to an accelerated MACRS method); and

7. changes in accounting for income and expenses that also affect depreciation or amortization deductions (e.g., costs capitalized to basis of depreciable assets rather than included in inventory).

Example 2F-2 Property not eligible for automatic change procedure.

XYZ Partnership is depreciating a building under 31.5-year MACRS. In 2010, the building is converted to a poultry facility that can be depreciated using 10-year MACRS. Also, after reviewing expense records, XYZ would like to capitalize and depreciate equipment that it expensed in 2007 under IRC Sec. 179.

XYZ cannot use Rev. Proc. 2008-52 to make any of these depreciation changes. The building is not eligible because only the use has changed and XYZ continues to own the property. In addition, Rev. Proc. 2008-52 specifically excludes accounting changes resulting from currently expensing to capitalizing and depreciating property (the equipment).

When automatic change procedures cannot be used, the general rules regarding accounting method change requests must be followed. This usually means filing Form 3115 pursuant to Rev. Proc. 97-27. An application for automatic approval of a change in accounting method will not be treated as an application under Rev. Proc. 97-27, which provides guidance for nonautomatic changes in accounting methods.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. The Thompson Partnership finds $78,000 of personal expenses have been accidentally deducted as business expenses. Which of the following is most accurate regarding this scenario?

    a. The Thompson Partnership must obtain IRS permission to correct the error.

    b. The Thompson Partnership does not have to change their method of accounting because of the error.

20. Which of the following revenue procedures applies to late elections that are not eligible for one of the automatic extensions?

    a. Rev. Proc. 97-27.

    b. Rev. Proc. 2002-28.

    c. Rev. Proc. 2010-1.

21. Which of the following best describes what happens when a partnership must change from an erroneous accounting method to a permissible one?

    a. The change will take place automatically, by filing an amended return.

    b. The change will be both retroactive and prospective.

    c. "Consistent treatment" of an item must occur on at least three returns.

    d. The partnership will file Form 3115.

22. Which of the following statements best describes what happens if a partnership discovers that it did not claim the full amount of allowable depreciation on a disposed asset that has been claimed for only one year?

    a. The partnership can correct the depreciation error on the asset by filing an amended return.

    b. The partnership is unable to correct the depreciation error if made on pervious year's returns.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. The Thompson Partnership finds $78,000 of personal expenses have been accidentally deducted as business expenses. Which of the following is most accurate regarding this scenario? **(Page 174)**

    a. The Thompson Partnership must obtain IRS permission to correct the error. [This answer is incorrect. IRS permission is not required to correct inaccurate estimates or errors.]

    b. The Thompson Partnership does not have to change their method of accounting because of the error. [This answer is correct. No change in accounting method is required because an error has occurred. Situations where factual or mathematical errors occur do not involve an accounting method change.]

20. Which of the following revenue procedures applies to late elections that are not eligible for one of the automatic extensions? **(Page 175)**

    a. Rev. Proc. 97-27. [This answer is correct. Under Rev. Proc. 97-27, limited relief is available for late applications that are not eligible for one of the automatic extensions only when the taxpayer can show that there were "unusual and compelling circumstances" for missing the filing deadline. To obtain relief under these nonautomatic provisions the partnership should request a letter ruling.]

    b. Rev. Proc. 2002-28. [This answer is incorrect. Rev. Proc. 2002-28 includes provisions under which a partnership with average annual gross receipts over $1 million may be able to use the cash method of accounting.]

    c. Rev. Proc. 2010-1. [This answer is incorrect. Rev. Proc. 2009-1 includes a list of the automatic change revenue procedures for changes that do not require IRS consent.]

21. Which of the following best describes what happens when a partnership must change from an erroneous accounting method to a permissible one? **(Page 177)**

    a. The change will take place automatically, by filing an amended return. [This answer is incorrect. Rev. Rul. 30-38 holds that a taxpayer cannot, without the IRS's consent, retroactively change from an erroneous to a permissible accounting method by filing an amended return (even if the statutory period for amending the return for the first year in which the erroneous method was used has not expired).]

    b. The change will be both retroactive and prospective. [This answer is incorrect. The change from an erroneous accounting method to a permissible method must be prospective, not retroactive. The IRS has the technical authority to grant retroactive changes. However, according to Rev. Rul. 90-38, taxpayers can request only prospective changes—except in certain limited and specified circumstances.]

    c. "Consistent treatment" of an item must occur on at least three returns. [This answer is incorrect. The same treatment of a material item in two or more consecutively filed tax returns represents "consistent treatment" of such item for purposes of Reg. 1.446-1(e). Consistent treatment means the taxpayer has established an accounting method.]

    d. The partnership will file Form 3115. [This answer is correct. Generally, IRS consent for a partnership to change an erroneous method of accounting is obtained by filing Form 3115 (Application for Change in Accounting Method).]

22. Which of the following statements best describes what happens if a partnership discovers that it did not claim the full amount of allowable depreciation on a disposed asset that has been claimed for only one year? **(Page 178)**

   a. **The partnership can correct the depreciation error on the asset by filing an amended return. [This answer is correct. For depreciation method changes, taxpayers are allowed to change an erroneous depreciation method for assets for which depreciation has only been claimed for one tax year. Alternatively, taxpayers can correct depreciation on these assets by filing an amended return.]**

   b. The partnership is unable to correct the depreciation error if made on pervious year's returns. [This answer is incorrect. This was true prior to Rev. Proc. 2007-16, which allows taxpayers to automatically change their accounting method for depreciation on certain disposed assets when they did not claim the full amount of depreciation allowable.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (T65TG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

9. Under which of the following methods of accounting is income reported in the year the property or cash is constructively or actually received?

   a. Accrual.

   b. Cash.

   c. Nonaccrual experience.

   d. Do not select this answer choice.

10. A partnership may not be allowed to use the cash method of accounting, even if otherwise it was permitted to do so, depending on which accounting methods are used by its partners.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

11. Rev. Proc. 2001-10 provides relief for many small businesses that would have to use the accrual method instead of the cash method due to the presence of inventories. The gross receipts test for this relief provision requires partnerships to have a three-year average annual gross receipts of no more than what amount?

    a. $1 million.

    b. $5 million.

    c. $10 million.

    d. $15 million.

12. Which of the following statements regarding the handling cost of materials under the cash method of accounting is accurate?

    a. Since inventory accounting rules do not apply to partnerships using the cash method, merchandise on hand at the end of the year can be deducted as cost of sales.

    b. Only the cost of materials and supplies that are actually consumed and used in operations during the tax year can be deducted by partnerships.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

13. Which of the following partnerships can use the nonaccrual experience (NAE) method of accounting on amounts received for services provided?

    a. Alpha partnership charges interest when customers fail to timely pay the amount charged for services.

    b. Beta partnership performs legal services and does not charge a penalty for failure to pay for services.

    c. Gamma partnership has average annual gross receipts of $6 million.

    d. Delta partnership performs services in the mining industry.

14. When is economic performance generally said to have occurred?

    a. When a partnership receives a payment for a recurring item.

    b. When the taxability of advance payments is deferred.

    c. When property or services are provided to or by a third party.

    d. When a note or other indication of indebtedness is issued.

15. Economic performance regulations provide several safe harbors. Under one such safe harbor, economic performance occurs when payment is made if the property or services are reasonably expected to be provided within how many months?

    a. One month.

    b. Three and a half months.

    c. Five and a half months.

    d. Twelve months.

16. "When payment is made" is critical to determining economic performance. Under the principles of which method of accounting is time of payment measured?

    a. Accrual.

    b. Cash.

    c. Nonaccrual experience.

    d. Do not select this answer choice.

17. If a partnership is required to change from the cash to the accrual method, what should be printed or typed at the top of its Form 3115 (Application for Change in Accounting Method)?

    a. "FILED PURSUANT TO REG. 301.9100-2."

    b. "FORM 1128 BACKUP ELECTION."

    c. "FILED UNDER REV. PROC. 2006-46."

    d. "AUTOMATIC CHANGE TO ACCRUAL METHOD—SECTION 448."

18. Which of the following is **not** considered an accounting method change?

    a. The determination that an accounting estimate was inaccurate.

    b. A change is the method of valuing inventory.

    c. The adoption of a specialized tax accounting method.

    d. A change from a long-term contract method to the accrual method.

19. The Xylo partnership needs an extension to file its change in accounting method. The change is required based on an election with deadlines that are prescribed in the regulations. The due date of the election is not the due date of the partnership's return. What extension is the partnership eligible to use?

    a. The automatic 6-month extension.

    b. The automatic 12-month extension.

    c. A nonautomatic extension.

    d. Do not select this answer choice.

20. When computing the Section 481(a) adjustment, generally, positive Section 481(a) adjustments are taken into income over four years. However, under the *De Minimis* rule, if a positive Section 481(a) adjustment is less than _______, the corporation may elect to use a ________ adjustment period.

    a. $50,000; two.

    b. $50,000; one.

    c. $25,000; two.

    d. $25,000; one.

21. Generally, partnerships that understate depreciation can file an amended return to correct the errors if the erroneous method was used for less than how many years?

    a. Two.

    b. Three.

    c. Four.

    d. Five.

22. Which of the following property types is eligible for the automatic change procedure?

    a. Intangible property that has been amortized under IRC Sec. 167 [aside from intangibles that were excluded from IRC Sec. 197 and amortized under IRC Sec. 167(f)].

    b. Accounting method changes when the taxpayer currently expenses the cost of property to capitalize and amortize or depreciate the cost.

    c. Property subject to amortization or depreciation under IRC Secs. 167, 168, or 197 for which more or less than the allowable amortization or depreciation was claimed and is held by the taxpayer at the beginning of the year of change.

    d. Property for which the taxpayer seeks to revoke or make an election under IRC Secs. 167, 168, or former IRC Sec. 168 or an election to retroactively apply Section 197 rules for the amortization of intangibles.

Lesson 3: Partnership Tax Elections

INTRODUCTION

For some purposes under the Internal Revenue Code, partnerships are treated as an aggregation of the partners, and the partners are considered to be the taxable entities (i.e., the *aggregate concept*). For other purposes, partnerships themselves are treated as taxable entities (i.e., the *entity concept*). The entity concept applies with respect to many tax elections. Partnerships can decide which fiscal year-end to select, choose an accounting method, and make many other elections. However, in some cases, the entity concept does not apply, and the partners make certain elections with respect to partnership activities. An example is the election to first reduce the basis of depreciable assets (rather than other tax attributes) for debt forgiveness income. This lesson focuses primarily on partnership level elections.

Most elections affecting the computation of income derived from a partnership must be made by the partnership. For example, electing depreciation methods, accounting methods, taxable years, electing to postpone gain realized on involuntary conversions, electing Section 179 expense deductions, selecting inventory methods, making Section 754 elections, electing out of the installment method, and electing to currently deduct intangible drilling and development costs that are all made by the partnership and not by the partners. All partnership elections are applicable to all partners equally, but any election made by a partnership shall not apply to any partner's nonpartnership interests. However, the following elections are made at the partner level, rather than at the partnership level (this is not an exhaustive list):

1. IRC Sec. 108(b)(5) or (c)(3) relating to income from discharge of indebtedness,
2. IRC Sec. 617 relating to deduction and recapture of certain mining exploration expenditures, and
3. IRC Sec. 901 relating to taxes of foreign countries and possession of the U.S.

Learning Objectives:

Completion of this lesson will enable you to:
- Make a check-the-box election and identify when to elect out of partnership tax provisions.
- Utilize the simplified filing rules for electing large partnerships and extensions on the time allowed for making an election.

Check-the-box Elections

The check-the-box regulations simplify the determination of whether an entity is taxed as a partnership or a corporation. Fundamentally, the regulations provide that an unincorporated multi-owner entity is by default taxed as a partnership unless the entity elects to be taxed as a corporation. There are several exceptions that must be considered. If an entity is classified under the default provisions as a partnership, no election is necessary to treat it as a partnership.

Example 3A-1 Electing entity status under the check-the-box regulations.

Casey and Carlton, both U.S. citizens, form All-Star Sporting Goods LLC (ASSG). They each own 50% of ASSG. Their attorney has drawn up the agreements and filed all necessary forms with the Secretary of State to be a limited liability company (LLC). They want to be treated as a partnership for tax purposes.

ASSG is considered an eligible entity that can choose to be taxed either as a corporation or as a partnership. If no election is made, the default classification is partnership status. The owners of ASSG should simply file Form 1065 and indicate on the form that it is an LLC. However, if the owners want ASSG to be classified as a corporation, a Form 8832 to elect corporate status must be completed and filed with the IRS.

A domestic or foreign eligible entity wishing to elect a classification different from its initial default classification must file an affirmative check-the-box election. The same is true when an eligible entity later wishes to change its existing classification. Failure to elect the different classification can cause adverse treatment.

An affirmative election is made by filing Form 8832 (Entity Classification Election) with the indicated IRS Service Center. Form 8832 should also be filed with the entity's tax return for the year the election is made (or the owner's tax return in the case of a single-owner entity whose existence is to be ignored for tax purposes).

The effective date of the election will be the date specified on Form 8832, as long as it is not more than 75 days prior to the election filing date or more than 12 months after the election filing date. If no date is specified, the effective date will be the election filing date. If the specified effective date violates the 75-day or 12-month rule, the effective date will be 75 days prior to the filing date or 12 months after the filing date, respectively.

Form 8832 must be signed by each owner of the entity or by an authorized officer, manager, or member if allowed under applicable local law or the entity's organizational documents.

Generally, a second check-the-box election cannot be made within 60 months after the effective date of the first such election. However, an entity can change its classification by election within the 60 months if more than 50% of the ownership interest in the entity as of the effective date of the second election is owned by persons who did not own any interests on the filing date or the effective date of the first election.

Rev. Proc. 2009-41 provides a simplified method to request relief for the late filing of an initial election by an eligible newly formed entity to be classified as other than the default classification provided under Reg. 301.7701-3(b). Following this revenue procedure is in lieu of the private letter ruling procedure (which requires the payment of fees) that is otherwise available. Rev. Proc. 2009-41 is not applicable to subsequent elections to change an entity's classification. An entity is eligible to follow Rev. Proc. 2009-41 if:

1. it failed to obtain its desired classification as of the date of its formation solely because Form 8832 was not filed timely;

2. Either (a) the entity has not filed a federal tax return for the first year in which the election was intended because the due date has not passed; or (b) the entity timely filed all required federal tax returns consistent with its requested classification for all years it intended the election to be effective (if no returns were required each affected person must have timely filed such returns as provided in the revenue procedure).

3. The election is made within three years and 75 days of the requested effective date.

4. the entity has reasonable cause for its failure to timely make the initial entity classification election.

A completed Form 8832 must be filed with the applicable Service Center. The words "FILED PURSUANT TO REV. PROC. 2009-41" must be written across the top of Form 8832. A statement must be attached to the form explaining the reason that the election was not timely filed.

Only rarely will it be advisable to change the classification of a multi-owner entity that is treated by default as a partnership for federal income tax purposes. Put another way, elections to change an entity's status from default classification as a partnership to status as an association taxed as a corporation (using Form 8832) will be few and far between.

Determining If a Partnership Exists and Electing to Be Excluded from the Partnership Tax Provisions

When Does a Partnership Exist for Tax Purposes?

In general, an unincorporated joint venture or other contractual or co-ownership arrangement under which several participants conduct a business or investment activity and split the profits is treated as a partnership for federal income tax purposes. This is the case even when the joint venture or arrangement is not recognized as a separate entity apart from its owners under applicable state law. Put another way, a partnership can be deemed to exist for federal income tax purposes even when there is no partnership for state-law purposes.

Arrangements that are generally deemed to be partnerships for federal income tax purposes include syndicates, groups, pools, joint ventures, and other unincorporated organizations through which any business, financial operation, or venture are carried on and which are not treated for federal income tax purposes as a corporation, trust, or estate.

However, mere co-ownership, rental, and maintenance of real property does not create a partnership for federal income tax purposes. Similarly, a mere agreement to share expenses does not create a partnership for federal income tax purposes.

Finally, when certain conditions are satisfied, the IRS allows "elections out" of partnership status for federal income tax purposes when partnership status would otherwise be deemed to exist. Opportunities to elect out are explained later in this lesson.

Avoiding partnership status is often desirable for at least three reasons:

- There is no need to file annual partnership returns on Form 1065 and issue Schedules K-1 to the co-owners. Instead, each co-owner simply reports the tax results from that person's ownership interest directly on the appropriate form or schedule (for example, on Schedule E of Form 1040 for an individual co-owner of real estate).

- Co-owners can make (or not make) tax elections (such as the Section 179 election) independently at the co-owner level.

- Co-owners can trade fractional real estate ownership interests in tax-deferred Section 1031 like-kind exchanges. In contrast, a partnership interest is by definition ineligible for Section 1031 treatment—even if the partnership's only asset is real estate.

Unfortunately, it is not always easy to determine when an unincorporated co-ownership arrangement should be treated as a partnership for federal income tax purposes, and that is a threshold concern for the discussion in the rest of this lesson. A recent Tax Court decision provided some helpful guidance on relevant factors to consider.

One Method for Determining If a Partnership Exists

In its 2010 *Holdner* decision, the Tax Court sided with the IRS by concluding that a profitable unincorporated farming, ranching, and timberland business conducted in Oregon by a father and son was a 50/50 partnership for federal income tax purposes. Therefore, the father's attempt to claim more than 50% of the venture's deductible expenses on his personal returns for 2004-2006 was disallowed. Apparently, the taxpayers' theory was that their venture was conducted by two interlocking sole proprietorships (one owned by the father and the other owned by the son) rather than by a partnership. The Tax Court did not agree. As a result, the father was determined to owe back taxes plus the 20% substantial understatement penalty.

In reaching this conclusion, the Tax Court looked at eight factors that were established many years ago in its 1967 *Luna* decision. The eight factors are listed below, along with how they were evaluated by the Tax Court in *Holdner* so that practitioners can understand the significance of each factor.

<u>Agreement of the Parties and Their Conduct in Executing Its Terms.</u> In *Holdner*, the parties (father and son) agreed to perform certain duties in running the operation and to evenly split the operation's gross income for the tax years in question (2004-2006). For those years, gross income totaled around $2 million dollars annually. The two parties faithfully followed this agreement. While there was no actual written agreement between the parties, this factor indicated the existence of a partnership.

<u>Contributions by the Parties.</u> In *Holdner*, both parties contributed capital and services. Therefore, this factor indicated the existence of a partnership.

<u>Control over Income and Capital and Right to Take Withdrawals.</u> In *Holdner*, both parties had equal access to and control over the operation's bank account, and each had unlimited power to take withdrawals. Therefore, this factor indicated the existence of a partnership.

<u>Whether Parties Were Co-Proprietors With Mutual Obligations to Share Losses.</u> In *Holdner*, both parties clearly shared a mutual proprietary interest in the operation's profits. However, their interest in losses was unclear. Overall,

however, the Tax Court felt that this factor indicated the existence of a partnership. (Without any apparent justification, the father claimed over 50% of the deductible expenses for 2004-2006 on his tax returns for those years, apparently to shelter income from his other activities.)

Whether Venture Was Conducted in Joint Names of Parties. In *Holdner*, the operation was conducted under the ambiguous name of Holdner Farms, which might have suggested that the operation was not limited to one particular member of the Holder family. The Tax Court felt that this factor did not contradict the existence of a partnership, but it did not support it either.

Whether Parties Filed Partnership Returns or Otherwise Represented to IRS or Others That Parties Were Joint Venturers. In *Holdner*, the parties did not file Forms 1065 with the IRS. However, they registered the operation as a partnership with the State of Oregon and represented that it was a partnership to their insurance company. Therefore, this factor indicated the existence of a partnership.

Whether Separate Books Were Maintained for the Venture. In *Holdner*, a separate bank account was set up for the venture, and meticulous financial records were kept. Therefore, this factor indicated the existence of a partnership.

Whether Parties Exercised Mutual Control over and Assumed Mutual Responsibilities for the Venture. It's hard to see how this factor differs from some of the other ones listed earlier. In any case, the Tax Court felt in *Holdner* that this factor indicated the existence of a partnership because each party had a crucial role in the operation and considered himself to be a co-owner.

No single factor is conclusive by itself. However, if more than half the factors indicate partnership status, generally it becomes much more difficult to defend the notion that the activity in question is *not* a partnership for federal income tax purposes.

Co-Owners Can Elect Out of Partnership Status in Some Circumstances

For some unincorporated co-ownership arrangements that might otherwise be classified as partnerships for federal income tax purposes, the co-owners can elect, under IRC Sec. 761(a) and related regulations, to be excluded from all the partnership provisions of the Internal Revenue Code (i.e., all of Subchapter K of the Code). This privilege of effectively electing out of partnership tax status is available in the following circumstances.

Jointly Owned Investment Property. To qualify for the election out privilege under this provision, the parties must own the investment property in question as co-owners, be able to dispose of their shares independently, and not actively conduct a business. The parties must be able to independently calculate their taxable income from the activity without the necessity of calculating partnership taxable income. For example, special allocations of income and deduction items cannot be made if the parties elect out of partnership status. This provision is often used to elect out of partnership status for real estate co-ownership arrangements.

Real estate co-ownerships under tenancy-in-common and joint tenancy arrangements often involve "mere co-ownership, rental, and maintenance of real property." As mentioned at the beginning of this section, such arrangements are not supposed to be considered partnerships anyway. Even so, making an affirmative election out of partnership status in the manner explained later in this key issue will remove any doubt.

Joint Operating Agreements. To qualify for the election out privilege under this provision, the parties must engage in the joint production, extraction, or use of property (such as oil, natural gas, or other minerals). The parties must own the property as co-owners or hold a lease granting exclusive operating rights as co-owners (such as an oil and gas lease). In addition, the parties must retain the right to separately take in kind their shares of the property produced, extracted, or used. They cannot jointly sell the property that is produced or extracted except under an arrangement that does not extend beyond one year. Finally, each party must be able to independently calculate taxable income from the activity without the necessity of calculating partnership taxable income. For example, special allocations of income and deduction items cannot be made if the parties elect out of partnership status. This provision is often used to elect out of partnership status for joint operating agreements to explore for and produce oil, natural gas, and minerals. Additional rules apply to joint operating agreements for natural gas production.

Dealers in Securities. Dealers in securities can qualify for the election out for short periods in conjunction with joint efforts to underwrite, sell, or distribute securities offerings.

The IRS has held that limited partnerships were not able to elect out of partnership classification under IRC Sec. 761. This determination was reached due to the fact that the partnerships were formed under the respective states' RULPA (Revised Uniform Limited Partnership Act). Under the RULPA, partners of a limited partnership are considered to own partnership interests in the partnership. Ownership of a partnership interest does not necessarily give a partner the right to take and dispose of the underlying partnership property. For this reason, the IRS ruled that partners under RULPA are not co-owners of partnership property and cannot take their share of the property at will. Thus, they did not meet the requirement of Reg. 1.761-2(a)(2)(i) and were not an eligible entity for purposes of IRC Sec. 761(a).

Why Elect Out?

Electing out generally affords the co-owners maximum tax flexibility with minimum administrative hassle. Advantages include the following:

1. Co-owners make their own tax elections, and there is no need to coordinate tax planning among members.

2. There is no need for a complicated and expensive partnership agreement.

3. There is no need to file partnership tax returns.

For these reasons, it is common for real estate and oil and gas joint ventures to elect out, when allowed.

Failure to recognize a business arrangement as a partnership and failure to elect out can have negative tax consequences. For example, partners in an oil and gas joint venture must elect to deduct intangible drilling costs (IDC) at the partnership level—unless they elect out and make their elections at the partner level. If no partnership return is filed, and no election out occurred, the individual participants' elections to deduct IDC incurred by the joint venture may be invalid. In addition, penalties apply when partnership returns are not filed when required.

Affirmatively Electing Out (Blank Form 1065 Method)

When allowed, co-owners can make an affirmative election out of partnership status by the due date, including any extension, for the partnership return for the first year the election out is desired. This is generally the first year of any activities that create any tax consequences for the co-owners. The affirmative election out is made by filing a blank Form 1065 that includes only the name or other identification of the organization, its address, and a statement containing the following:

1. The name, address, and taxpayer identification number for each co-owner.

2. A statement that the organization qualifies for one of the aforementioned provisions that allow the election out privilege.

3. A statement that all co-owners members elect to be excluded from the provisions of Subchapter K (the partnership tax rules).

4. A statement indicating the location of a copy of the agreement under which the organization operates. If it is an oral agreement, the statement must identify a person that can be contacted regarding the agreement's provisions.

Example 3B-1: Election out for jointly-owned real estate.

As tenants in common, Matt and Cody own equal 50% interests in a rental real estate property. They share everything equally. They want to elect out of partnership status in order to avoid the hassle of complying with the partnership tax rules and having to prepare and file Form 1065 and Schedules K-1 for each year. Therefore, in their initial year of ownership, the co-owners file an affirmative election out of partnership status by using the blank Form 1065 method explained above. Accordingly, each co-owner calculates his own tax results from his ownership interest each year and reports those results on his own Form 1040 for that year.

As mentioned earlier, an election out may not be necessary under the facts in this example, but it's better to be safe than sorry.

Example 3-1: Election out for oil and gas joint venture.

Mindy, Louise, and Cindy each own leases granting one-third operating mineral right interests in some oil and gas acreage. They intend to drill one or more wells on the property and agree to share all expenses and any resulting production equally under a joint operating agreement. Arrangements like this are often called joint ventures in the oil and gas business (as opposed to more complicated arrangements that are *intended* to be partnerships for tax purposes).

Mindy, Louise, and Cindy want to elect out of partnership status in order to avoid the hassle of complying with the partnership tax rules and having to prepare and file Form 1065 and Schedules K-1 for each year. Therefore, in the initial year of their joint venture, they make an affirmative election out of partnership status using the blank Form 1065 method. Accordingly, each individual calculates her own tax results from her operating interest each year and reports those results on her own Form 1040 for that year. (Assume the joint operating agreement meets all the requirements to be eligible for the election out of partnership taxation.)

Electing Out Based on Facts and Circumstances

The second way to elect out of partnership status is to show that, based on facts and circumstances, the co-owners always intended to be excluded from Subchapter K of the Internal Revenue Code starting with the arrangement's first tax year.

When Not to Elect Out

Electing out is not advisable under the following circumstances (this is not an all-inclusive list):

1. The partnership wants to make special allocations (for example, deductions for intangible drilling costs or depreciation).

2. The organization is unsure it meets the conditions to elect out. For example, oil and gas property co-owners may have jointly entered into a long-term gas marketing contract. An invalid election out means the tax elections made by the individual partners may be invalid because the elections should have been made at the partnership level. In addition, the penalty for failing to file a partnership return when one is required can be expensive (the penalty is explained later in this key issue). For these reasons, a good rule of thumb is: "If in doubt, don't try to elect out."

3. The partners want to use a different accounting method than they use themselves. (Setting up a partnership allows the partnership to select its own method of accounting.)

Electing Out for Husband-Wife Qualified Joint Ventures

An unincorporated business activity that is properly classified as a husband-wife partnership for federal income tax purposes must comply with the partnership tax provisions, file an annual Form 1065, and issue annual Schedules K-1 to both spouses. (See the discussion earlier in this lesson about when a partnership is deemed to exist, or not.)

Fortunately, the Small Business and Work Opportunity Tax Act of 2007 established an exception to the preceding general rule. Under the exception, eligible unincorporated husband-wife businesses are allowed to elect out of partnership tax status for federal income tax purposes and thereby avoid the federal income tax compliance headaches associated with partnership status. To be eligible for the election out, the spouses must file jointly, and the husband-wife business must be a qualified joint venture (QJV).

After electing out of partnership tax status, the spouses must separately report their respective shares of QJV tax items on the appropriate IRS forms. For example, income and expenses from a non-farming QJV activity would generally be reported on separate Schedules C or E, and income and expenses from a farming QJV activity would be reported on separate Schedules F.

Similarly, the spouses must separately report their respective shares of QJV net self-employment (SE) income (if any) on separate Schedules SE. Each spouse then receives credit for his or her share of the SE income for Social Security benefit eligibility purposes.

Definition of Qualified Joint Venture. A qualified joint venture (QJV) is an unincorporated business venture where:

- The husband and wife are the only members.
- Both spouses materially participate in the venture's business.
- The spouses file a joint return and elect out of partnership tax status in the manner explained below.

How to Elect Out. The election out is accomplished by the spouses separately reporting their respective shares of tax items from the QJV and separately reporting their shares of SE income (if any) from the QJV in the fashion explained earlier.

Electing out will not change the couple's joint federal income tax liability or their joint SE tax liability.

Husband-Wife Rental Real Estate Business Can Be Qualified Joint Venture. The IRS admits that an unincorporated husband-wife rental real estate activity can meet the definition of a QJV and thus be eligible for the election out of partnership tax status. To make the election out for a rental real estate QJV, the IRS currently instructs the spouses to report their respective shares of income and expense items from the QJV on separate Schedules C.

Unfortunately, this approach causes some complications because income and expense items from rental real estate activities are generally reported on Schedule E, rather than on Schedule C. The Schedule E versus Schedule C distinction is important because net income from a Schedule C activity is generally subject to SE tax. If so, it should be reported on Schedule SE. In contrast, net income from a Schedule E rental real estate activity is not subject to SE tax, and it should not be reported on Schedule SE. However, reporting QJV rental real estate income and expenses on Schedule C may cause the IRS to expect to see a related Schedule SE for each spouse and related SE tax on page 2 of Form 1040 even though no SE tax is actually due.

Mere co-ownership, rental, and maintenance of real property does not create a partnership for federal income tax purposes. Therefore, it may often be possible to take the position that a husband-wife rental real estate operation is not a partnership for tax purposes. In such case, there is no need to use the QJV election out privilege, and the income and expenses from the activity can simply be reported on Schedule E without any complications.

Special Rules for Unincorporated Businesses in Community Property States

In community property states, Rev. Proc. 2002-69 stipulates that the IRS will respect a married taxpayer's treatment of an unincorporated business as either a sole proprietorship or a husband-wife partnership.

Put another way, when a married couple treats their eligible unincorporated business as a sole proprietorship for federal tax purposes, the IRS will not object—even when both spouses are active in the business. Alternatively, when a married couple treats their eligible unincorporated business as a husband-wife partnership for federal tax purposes (and they file partnership returns), the IRS will not object to that treatment either—even if only one spouse is active in the business.

The relief provisions offered by Rev. Proc. 2002-69 are limited to qualified business entities. A qualified business entity is one that meets all three of the following requirements:

1. It is wholly owned by husband and wife as community property under the laws of a state, foreign country, or U.S. possession.
2. No person other than the husband or wife (or both) would be considered an owner for federal tax purposes.
3. It is not treated as a corporation under the check-the-box entity classification rules of Reg. 301.7701-2.

According to Rev. Proc. 2002-69, the rules explained above apply "for federal tax purposes" which means they apply for federal self-employment (SE) tax purposes as well as for federal income tax purposes. Therefore, community property state residents who own profitable qualified business entities should consider treating them as sole proprietorships when doing so would produce SE tax savings.(See Example 5B-3.) In most cases, the only federal income tax impact of such treatment will be preparing Schedule C, E, or F for the activity instead of Form 1065 and the related Schedules K-1.

Example 3-2: Treating unincorporated husband-wife business as sole proprietorship pursuant to Rev. Proc. 2002-69.

Donald and Diane are married residents of a community property state. Pursuant to Rev. Proc. 2002-69, they treat their unincorporated 50/50 husband-wife business, which produces 2010 SE income of $200,000, as a sole proprietorship operated by Diane for federal tax purposes. Assume that Donald and Diane have no wage income and no other SE income from other sources.

The treatment of the business as Diane's sole proprietorship results in a 2010 SE tax bill of $18,560 [($106,800 × .124) + ($200,000 × .9235 × .029)]. If the business is instead treated as a 50/50 husband-wife partnership, the 2010 SE tax bill would be a whopping $28,299 ($100,000 × .9235 × .153 × 2).

In this example, the sole proprietorship treatment results in SE tax savings because less SE income is hit with the 12.4% Social Security tax component of the SE tax. This is because the entire $200,000 of SE income is reported on Diane's Schedule SE where only the first $106,800 of SE income (for 2010) is hit by the 12.4% Social Security tax component of the SE tax. In contrast, if the business is treated as a 50/50 partnership between Donald and Diane, each spouse must report $100,000 of SE income on his or her separate Schedule SE, and that would result all $200,000 of the SE income being hit with the 12.4% Social Security tax component of the SE tax.

In some cases, it may be beneficial to take the opposite approach and treat an eligible husband-wife business as a partnership pursuant to Rev. Proc. 2002-69. For instance, this treatment could reduce a married couple's SE tax bill when the husband has wage income above the Social Security tax ceiling ($106,800 for 2010). Using partnership treatment to allocate SE income to the husband and away from the wife could produce a lower SE tax liability than if the business is treated as the wife's sole proprietorship.

Beware of Penalty for Failing to File Partnership Returns

The Worker, Homeownership, and Business Assistance Act of 2009 increased the monthly penalty for failing to file a partnership return on Form 1065 or failing to provide required information on the return to $195 per partner (up from $89). The penalty can be assessed for a maximum of 12 months. The increased penalty applies to Forms 1065 required for tax years beginning after 12/31/09.

For example, the maximum penalty for failing to file a calendar-year 2010 Form 1065 for an unincorporated two-person business that must be treated as a partnership would be $4,680 (2 × $195 × 12).

The existence of this harsh penalty obviously dictates in favor of filing partnership returns in borderline cases. Whenever there is any doubt, clients should be informed of the failure-to-file penalty, and clients (not practitioners) should make the decision about whether or not to file partnership returns.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. The Bellmaker's Group is a domestic entity with multiple owners. The entity wishes to change its existing classification as a corporation and be taxed as a partnership. How should Bellmaker's Group file the necessary affirmative check-the-box election?

    a. File form 8832 with the indicated IRS Service Center and also with the entity's tax return in the year the election is made.

    b. File the election by the federal tax return due date (excluding extensions) for the tax year in which the Bellmaker's Group was formed.

    c. File a copy of Form 3115 with the timely filed (including extensions) original federal income tax return for the year of change and with the IRS National Office.

24. If a partnership's only asset is real estate, a partnership interest is __________ for Section 1031 treatment.

    a. Eligible.

    b. Ineligible.

25. Which of the following statements regarding partnership status of co-owners is accurate?

    a. All co-owners of unincorporated co-ownership arrangements are bound by the partnership provisions of the Internal Revenue Code.

    b. Co-owners of some unincorporated co-ownership arrangements can elect to be excluded from all the partnership provisions of Subchapter K of the Internal Revenue Code.

26. What advantage might a partnership realize if it elects out of the partnership provisions under IRC Sec. 761(a)?

    a. A partnership agreement will not be needed.

    b. Special allocations can be used.

    c. Tax planning can be coordinated among members.

    d. The partners can have different accounting methods from the partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

23. The Bellmaker's Group is a domestic entity with multiple owners. The entity wishes to change its existing classification as a corporation and be taxed as a partnership. How should Bellmaker's Group file the necessary affirmative check-the-box election? **(Page 188)**

    a. File form 8832 with the indicated IRS Service Center and also with the entity's tax return in the year the election is made. [This answer is correct. An affirmative election is made by filing Form 8832 (Entity Classification Election) with the IRS Service Center. Form 8832 should also be filed with the entity's tax return for the year the election is made.]

    b. File the election by the federal tax return due date (excluding extensions) for the tax year in which the Bellmaker's Group was formed. [This answer is incorrect. This simplified method found in Rev. Proc. 2002-59 is used to request relief for the late filing of an initial election by an eligible newly formed entity to be classified as other than the default classification provided under Reg. 301-7701-3(b).]

    c. File a copy of Form 3115 with the timely filed (including extensions) original federal income tax return for the year of change and with the IRS National Office. [This answer is incorrect. This is the filing method used for applications to change accounting methods under Rev. Proc. 2009-41.]

24. If a partnership's only asset is real estate, a partnership interest is _________ for Section 1031 treatment. **(Page 189)**

    a. Eligible. [This answer is incorrect. Co-owners, not partnerships can trade fractional real estate ownership interests in tax-deferred Section 1031 like-kind exchanges per IRC Sec. 1031 (a)(2)(D).]

    b. Ineligible. [This answer is correct. A partnership interest is by definition ineligible for Section 1031 treatment, even in cases where the partnership's only asset is real estate as cited in IRC Sec. 1031(a)(2)(D).]

25. Which of the following statements regarding partnership status of co-owners is accurate? **(Page 190)**

    a. All co-owners of unincorporated co-ownership arrangements are bound by the partnership provisions of the Internal Revenue Code. [This answer is incorrect. Co-owners of some unincorporated co-ownership arrangements can elect under IRC Sec. 761(a) and related regulations, to be excluded from all the partnership provisions of the Internal Revenue Code.]

    b. Co-owners of some unincorporated co-ownership arrangements can elect to be excluded from all the partnership provisions of Subchapter K of the Internal Revenue Code. [This answer is correct. In circumstances such as jointly owned investment property under IRC Sec. 761(a)(1) and Reg. 1.761-2(a)(1) and (a)(2); joint operating agreements under IRC Sec. 761(a)(2) and Reg. 1.761-2(a)(3), and (d); and dealers in securities under IRC Sec. 761(a)(3), co-owners of some unincorporated co-ownership arrangements that might otherwise be classified as partnerships for federal income tax purposes can elect-out of partnership tax status.]

26. What advantage might a partnership realize if it elects out of the partnership provisions under IRC Sec. 761(a)? **(Page 192)**

    a. A partnership agreement will not be needed. [This answer is correct. Electing out generally affords the co-owners maximum tax flexibility with minimum administrative hassle. There is no need for a complicated and expensive partnership agreement or to file a partnership tax return.]

    b. Special allocations can be used. [This answer is incorrect. If a partnership wants to make special allocations (for example, deductions for intangible drilling costs or depreciation), it typically should not elect out of the partnership provisions.]

    c. Tax planning can be coordinated among members. [This answer is incorrect. This is not an advantage of electing out of the partnership provisions. Electing out would allow co-owners to make their own tax elections and save them from the hassle of coordinating tax planning among members.]

    d. The partners can have different accounting methods from the partnership. [This answer is incorrect. If partners want the partnership to use a different accounting method than they use themselves, they should not elect out of the partnership provisions. Setting up a partnership allows the partnership to select its own method of accounting.]

Simplified Filing Requirements for Electing Large Partnerships

IRC Secs. 771 through 777 simplify filing requirements for electing large partnerships. The electing large partnership rules, if elected, will prevail over the ordinary partnership rules. As a result, the character of some partnership items will not pass through to the partners because some items will be netted at the partnership level.

In general, an electing large partnership is defined as a partnership with 100 or more partners in the preceding partnership tax year that elects to be treated as a large partnership. Thus, a partnership cannot make the election for its first tax year. The number of partners is determined by counting only persons directly holding partnership interests, including persons holding through nominees.

The election to be treated as a large partnership is applicable for the year made and for all subsequent years unless revoked with the consent of the IRS. The election is made by filing Form 1065B but is not available for partnerships in which the partners (1) perform substantial services in connection with the partnership's activities; (2) are retired partners, who had performed such substantial services; or (3) are spouses of partners who are performing or had previously performed such services. For purposes of determining if partners perform substantial services, the activities of the partnership include the activities of any other partnership or LLC in which the upper-tier partnership owns an interest in the capital and profits of at least 80%. If a partnership is treated as an electing large partnership on its Form 1065, that treatment is binding on the partnership and all of its partners, but not on the IRS. Once made, the election applies to the tax year for which it was made, and all subsequent tax years unless revoked with IRS consent. A partnership will cease to be treated as an electing large partnership for any partnership tax year if in such tax year fewer than 100 persons were partners.

Computation of Taxable Income

The taxable income of an electing large partnership is computed in the same manner as that of an individual except that the items described in IRC Sec. 772(a) will be separately stated (see the list in the following paragraph). In addition, deductions for personal exemptions, net operating losses, and itemized deductions for individuals under IRC Secs. 211 through 220 (other than Section 212 deductions) are not allowed. Charitable deductions are subject to the limitations in IRC Sec. 170(b)(2) that apply to corporations (and are not separately stated), and 70% of miscellaneous itemized deductions are disallowed (versus the 2% disallowed to individuals).

Simplified Flow-through

The following is a list of the items that are separately stated for electing large partnerships:

1. income or loss from passive loss limitation activities;
2. income or loss from other activities (e.g., portfolio income or loss);
3. net capital gain or loss separated for amounts allocable to passive loss activities and from other activities;
4. tax-exempt interest;
5. applicable net AMT adjustment separately computed for passive loss activities and other activities;
6. general credits, low-income housing credits, and rehabilitation credits;
7. foreign income taxes;
8. credits allowed under IRC Sec. 29 for producing fuel from nonconventional sources;
9. discharge of indebtedness income;
10. qualified dividend income;
11. qualified production activity income; and
12. any other items determined by the IRS that are appropriately reported as separately stated items.

Under the electing large partnership rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. The IRS has the right to assess any additional tax against a partner for inconsistent treatment. The IRS has issued a standardized form for electing large partnerships, Form 1065B, since many of the separate line items will no longer be broken out.

Each tax-exempt partner subject to tax on unrelated business taxable income (UBTI) must take its distributive share of partnership items into account separately to the extent necessary to comply with the rules for the pass-through of the partnership's UBTI.

Elections and Limitations

All elections and limitations affecting the computation of taxable income are applied at the partnership level. This general rule has exceptions for the foreign tax credit, election to exclude discharge of indebtedness income, overall limitation on itemized deductions, at-risk limitation, and passive activity limitations.

Termination of an Electing Large Partnership

An electing large partnership terminates when all its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership. Unlike other partnerships, an electing large partnership does not terminate upon the sale or exchange of 50% or more of the partnership interests in capital and profits within a 12-month period, also known as a technical termination.

Other Specially Treated Items

Certain other items regarding electing large partnerships receive special treatment, including:

1. A member's distributive share is adjusted to take into account any optional basis adjustment.

2. Any credit recapture is taken into account by the partnership, and the amount of recapture is determined as if the credit had been fully used to reduce tax. The credit recapture is taken into account by reducing the amount of the current year credit to the extent of the current year credit; the partnership pays tax on any recapture that exceeds the current year credit. No credit recapture is required by reason of any transfer of an interest in an electing large partnership.

3. The technical termination rules providing for the termination of a partnership if there is a 50% or more change in ownership during a 12-month period do not apply to an electing large partnership.

4. The credits under IRC Secs. 34 and 852(b)(3)(D) are allowed to the partnership and not taken into account by the members.

5. An electing large partnership is subject to the tax imposed on partnerships that hold REMIC residual interests as if all the interests in the partnership were held by disqualified organizations.

6. The installment sale interest charge is applied at the partnership level. In determining the amount of the interest charge, the partnership is subject to tax at the highest corporate or noncorporate tax rate.

7. Special rules included in IRC Sec. 776 apply to partnerships holding oil or gas properties.

Extending the Time for Making a Partnership Election

Reg. 301.9100-1 grants the IRS authority to extend the time for making an election or allow relief for failure to make a timely election. Generally, the IRS can grant a reasonable extension of time to make an election whose deadline is prescribed by a regulation (a regulatory election) or Code section (a statutory election) if (1) the taxpayer acted reasonably and in good faith and (2) granting relief will not prejudice the interests of the government. For statutory elections, the extension period cannot be more than six months, except in the case of a taxpayer who is abroad. An extension of time is not available for elections expressly excepted from relief or where relief is provided in another statute, regulation, or IRS pronouncement.

Automatic Extensions

Certain elections are eligible for automatic extensions of either 12 months or six months. Returns or election statements filed under either of these automatic relief provisions should have the following statement at the top of the document: "FILED PURSUANT TO REG. 301.9100-2." Such returns or documents are filed at the same address where the election should have been filed. No letter ruling, and thus no user fee, is required for obtaining an automatic extension.

Automatic 12-month Extension. Certain regulatory elections are eligible for an automatic 12-month extension from the due date, provided the taxpayer takes corrective action within the 12-month extension period. If the "due date" of the election is the due date of the return, the 12-month extension period begins on the extended due date of the return, if an extension was obtained. This extension is available regardless of whether the return for the year the election should have been made was filed timely. Some of the eligible elections include the (1) Section 444 election to use a tax year other than a required tax year, (2) Section 472 election adopting the LIFO inventory method, (3) Section 528 election to be treated as a homeowners association, and (4) Section 754 optional basis adjustment for certain partnership transfers and distributions.

Corrective action by the taxpayer means that an original or amended tax return containing the appropriate form or statement is filed within the 12-month extension period for the year the election should have been made. If the election is not made with a return, it should be filed in the manner prescribed by the statute, regulations, or other IRS pronouncement. In addition, the electing taxpayer and any other taxpayer whose tax liability is affected by the election must report their income in a manner consistent with the election and comply with all other requirements for making the election.

Automatic Six-month Extension. An automatic six-month extension from the due date of a return excluding extensions is granted to make statutory or regulatory elections with deadlines prescribed as the due date of the return or the due date including extensions as long as the taxpayer timely files his or her return for the year the election should have been made. This allows taxpayers to make the election no later than six months after the original (unextended) due date of the return for the tax year in which the election should have been made. When the period for taking corrective action has expired, no relief can be granted.

To qualify for the automatic six-month extension, taxpayers must take corrective action (as defined previously) within the six-month extension period. Also, the taxpayer must have timely filed the tax return for the year the election should have been made.

Other (Nonautomatic) Extensions

Relief is also available for regulatory elections not eligible for the automatic extensions provided by Reg. 301.9100-2. In these cases, taxpayers must establish that (1) they acted reasonably and in good faith, and (2) granting relief will not prejudice the interests of the government.

Reasonable Action and Good Faith. Taxpayers are deemed to have acted reasonably and in good faith if they:

1. apply for relief before IRS discovery of the untimely election;

2. inadvertently failed to make the election because of intervening events beyond their control;

3. failed to make the election because, after exercising reasonable diligence (taking into account their experience and the complexity of the return or issue), they were unaware of the necessity of the election;

4. reasonably relied on the written (not oral) advice of the IRS; or

5. reasonably relied on a qualified tax professional (including an employee) who failed to make or advise the taxpayer to make the election. This does not apply if the taxpayer knew, or should have known, that the tax professional was not competent to render advice on the election, or was unaware of all relevant facts.

A taxpayer has not acted reasonably and in good faith if the taxpayer:

1. seeks to change a return position for which an accuracy-related penalty could be or has been imposed and the new position requires or permits an election for which relief is requested;

2. was fully informed of the required election and the related tax consequences, but chose not to make it; or

3. uses hindsight in requesting relief.

Prejudice the Interests of the Government. The IRS will not grant an extension if the government's interests are prejudiced, which occurs if either of the following occurs:

1. Granting relief makes the taxpayer's aggregate tax liability for all years affected by the election lower than it would have been had the election been timely made (considering the time value of money). If the election affects more than one taxpayer, this determination is based on the taxpayers' combined tax liabilities.

2. The tax year in which the election should have been made or any affected tax years are now closed by the statute of limitations. However, the IRS may grant relief if the taxpayer provides a statement from an independent auditor (i.e., one that did not advise the taxpayer regarding making the election) that the taxpayer's aggregate tax liability would not be lowered if the election were made.

Special rules apply to accounting method regulatory elections. For example, the government's interests are deemed to be prejudiced except in unusual and compelling circumstances if the (1) accounting method election requires the filing of Form 3115 (Application for Change in Accounting Method) to obtain the advance written consent of the IRS or (2) accounting method election requires a Section 481 adjustment.

A special rule applies to accounting period regulatory elections. For these elections (other than an election under IRC Sec. 444), the government's interests are deemed to be prejudiced except in unusual and compelling circumstances if the request for relief is filed more than 90 days after the deadline for filing the Form 1128 (Application to Adopt, Change, or Retain a Tax Year).

How to Request Relief. Requests for a nonautomatic extension must be made via a letter ruling accompanied by the applicable user fee. The request must include affidavits and declarations from the taxpayer and other individuals having knowledge or information about the events leading to the failure to make the election timely. Each affidavit must be signed under penalties of perjury. The taxpayer must also (1) provide the IRS with the status of any examinations concerning the returns affected by the election, (2) state when the election was required to be filed and when it was actually filed, and (3) submit copies of any documents that refer to the election.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Which of the following statements most accurately describes the tax treatment of a partnership that elects large partnership status?

    a. Partners must report all partnership items that are inconsistent with the partnership's return.

    b. Tax-exempt interest and foreign income taxes must be separately stated.

    c. Personal exemption deductions are reported in the same manner as on an individual's return.

    d. Two percent of miscellaneous itemized deductions are disallowed.

28. Under what conditions will an electing large partnership terminate?

    a. When all of its operations have been discontinued and no part of any financial operation, business, or venture is continued by any of the partners.

    b. When 50% or more of the partnership interests in capital and profits are sold or exchanged within a 12-month period.

29. Under which of the following circumstances will the IRS generally **not** grant an extension because the government's interests would be considered prejudiced?

    a. Granting the relief will make the aggregate tax liability higher for all the years affected by the election.

    b. The tax year in which the election should have been made is closed by the statute of limitations.

    c. The taxpayer is deemed not to have acted reasonably or in good faith.

30. If a partnership wishes to request a nonautomatic extension from the IRS, which of the following steps should it take?

    a. A waiver must be included to exempt the partnership from any user fees.

    b. The amended tax return must be filed within 12 months.

    c. The request must include affidavits signed under penalties of perjury.

    d. Election statements must be filed that say "FILED PURSUANT TO REG. 301.9100-2."

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. Which of the following statements most accurately describes the tax treatment of a partnership that elects large partnership status? **(Page 198)**

    a. Partners must report all partnership items that are inconsistent with the partnership's return. [This answer is incorrect. Under the electing partnership rules, a partner is not permitted to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency.]

    b. Tax-exempt interest and foreign income taxes must be separately stated. [This answer is correct. The taxable income of an electing large partnership is computed in the same manner as that of an individual with only a few exceptions. One exception is that the items described in IRC Sec. 772(a) will be separately stated. Tax-exempt interest and foreign income taxes are on that list. Other items that must be stated separately include income or loss from passive loss limitation activities, discharge of indebtedness income, and qualified dividend income.]

    c. Personal exemption deductions are reported in the same manner as on an individual's return. [This answer is incorrect. Deductions for personal exemptions, net operating losses, and itemized deductions for individuals under IRC Secs. 211 through 220 (other than Section 212 deductions) are not allowed for electing large partnerships.]

    d. Two percent of miscellaneous itemized deductions are disallowed. [This answer is incorrect. This is true for individual taxpayers. For an electing large partnership, 70% of miscellaneous itemized deductions are disallowed.]

28. Under what conditions will an electing large partnership terminate? **(Page 199)**

    a. When all of its operations have been discontinued and no part of any financial operation, business, or venture is continued by any of the partners. [This answer is correct. This statement correctly describes the termination circumstances of an electing large partnership, which are different than those of other partnerships.]

    b. When 50% or more of the partnership interests in capital and profits are sold or exchanged within a 12-month period. [This answer is incorrect. This statement describes a technical termination, which is how partnerships that are not electing large partnerships are terminated.]

29. Under which of the following circumstances will the IRS generally **not** grant an extension because the government's interests would be considered prejudiced? **(Page 201)**

    a. Granting the relief will make the aggregate tax liability higher for all the years affected by the election. [This answer is incorrect. The government's interests would be considered prejudiced if granting relief makes the taxpayer's aggregate tax liability for all years affected by the election lower than it would have been had the election been timely made (considering the time value of money). If the election affects more than one taxpayer, this determination is based on the taxpayers' combined tax liabilities.]

    b. The tax year in which the election should have been made is closed by the statute of limitations. [This answer is correct. If the tax year in which the election should have been made or any affected tax years are now closed by the statute of limitations, the IRS will not grant an extension because the government's interests would be considered prejudiced. However, the IRS may grant relief if the taxpayer provides a statement from an independent auditor that the taxpayer's aggregate tax liability would not be lowered if the election were made.]

    c. The taxpayer is deemed not to have acted reasonably or in good faith. [This answer is incorrect. There are two qualifications that must be met for a taxpayer that is ineligible for the automatic extensions to receive extensions from the IRS. The taxpayer must establish that they acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. These two qualifications are separate and can be considered met by differing sets of circumstances.]

30. If a partnership wishes to request a nonautomatic extension from the IRS, which of the following steps should it take? **(Page 201)**

    a. A waiver must be included to exempt the partnership from any user fees. [This answer is incorrect. Requests for a nonautomatic extension must be made via a letter ruling accompanied by the applicable user fee.]

    b. The amended tax return must be filed within 12 months. [This answer is incorrect. If the partnership were filing for the automatic 12-month extension this would be the necessary corrective action. The appropriate form or statement would need to be included.]

    c. The request must include affidavits signed under penalties of perjury. [This answer is correct. The request for the nonautomatic extension must include affidavits and declarations from the taxpayer and other individuals having knowledge or information about the events leading to the failure to make the election timely. Each affidavit must be signed under penalties of perjury.]

    d. Election statements must be filed that say "FILED PURSUANT TO REG. 301.9100-2." [This answer is incorrect. If the partnership were filing for an automatic extension, this statement would need to be included at the top of the filed returns or election statements.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (T65TG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

23. The Coleman Group is a multi-owner entity that wishes to be taxed as a partnership, not as a corporation. Is an election necessary?

    a. Yes.

    b. No.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

24. Once an entity has made its first check-the-box election, how long after the effective date of the first election must the entity wait before making a second check-the-box election?

    a. 60 days.

    b. 90 days.

    c. 30 months.

    d. 60 months.

25. If a partnership is not recognized for state-law purposes, it cannot be deemed to exist for federal income tax purposes.

    a. True.

    b. False.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

26. Which of the following arrangements is generally deemed to be a partnership for federal income tax purposes?

    a. Co-ownership of real property.

    b. An agreement to share expenses.

    c. Joint venture.

    d. Maintenance of real property.

27. Which set of rules is dominant when elected?

    a. Ordinary partnership rules.

    b. Large partnership rules.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

28. Which of the following partnerships qualifies to elect the large partnership filing requirements?

    a. Gum Brothers had 105 partners in the preceding partnership tax year.

    b. All partners of Stackhouse Enterprises perform substantial services for partnership activities.

    c. Lively Limited has 110 partners in this partnership tax year and 78 partners in the previous year.

    d. This is the first year of operation for the Calvery-Breaker partnership.

29. The E-Squared partnership's tax return was due on December 31, and the partnership filed its return on time. The following March, the partnership realizes that, despite adequate due diligence, it did not make an election to which it would have been entitled. On June 1, the partnership takes the appropriate corrective action to make the missed election. What IRS extension has E-Squared used in this scenario?

    a. The automatic 6-month extension.

    b. The automatic 12-month extension.

    c. A nonautomatic extension.

    d. Do not select this answer choice.

30. List all of the following circumstances under which a taxpayer will be deemed to have acted reasonably and in good faith when making regulatory elections.

    i. Applying for relief before IRS discovery of an untimely election.

    ii. Using hindsight to request relief.

    iii. Failing to make an election because they reasonably relied on a qualified tax professional who did not make or advise them to make the election.

    iv. Despite due diligence, failing to make an election because they were unaware of the necessity to do so.

    v. Failing to make an election inadvertently due to events beyond their control.

    vi. Failing to make an election because they reasonably relied on written IRS advice.

    vii.. Seeking to change a position on a return for which an accuracy-related penalty could be (or has been) imposed, and the new position permits or requires an election for which relief is requested.

    viii. Choosing not to make an election despite being fully informed about the election and its tax consequences.

    a. iii. and vi.

    b. ii., vii., and viii.

    c. i., iii., iv., v., and vi.

    d. i., ii., iii., iv., v., vi., vii., and viii.

Lesson 4: The TMP, Amended Returns, and Due Diligence in Form 1065 Preparation

INTRODUCTION

Partnerships are required to file, and occasionally amend, Form 1065 and related Schedules K-1. Although the tax treatment of partnership items is determined at the individual partner level rather than at the partnership level, consistent treatment of such items is required among the returns of the partnership and the partners.

This lesson discusses the TMP, filing amended partnership returns, knowing the statute of limitations for partnership items, and penalties.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the rules related to tax matters partners (TMPs) and requesting administrative adjustments.
- Determine partnership and nonpartnership items, including the statute of limitations for partnership items.
- Identify issues that might result in penalties and ways to avoid them.

The Tax Matters Partner (TMP)

Under the Tax Equity Fiscal Responsibility Act (TEFRA) consolidated partnership audit procedures, every partnership is required to have a "Tax Matters Partner (TMP)." The TMP is responsible for representing the partnership in unified partnership audit proceedings. The TMP receives the audit notification, conducts the audit, and enters into a settlement agreement on behalf of the partners. The rules for determining the TMP are in IRC Sec. 6231(a)(7) and Reg. 301.6231(a)(7)-1.

The IRS has placed the TEFRA examination guide on its website in the "Businesses" section.

Generally, a partnership can designate any general partner as the TMP. The only restrictions are:

1. the general partner must have been a partner at some time during the tax year for which the designation is made or must be a partner at the time the designation is made, and

2. a partner who is not a U.S. citizen or resident, a domestic partnership, a domestic corporation, or a U.S. estate or trust cannot be designated as the TMP without the Commissioner's consent.

How to Make the TMP Designation

The partnership must designate a TMP each year. The designation generally is made by completing the section on Page 3 of Form 1065 titled "Designation of Tax Matters Partner." The information requested in this section of Form 1065 is as follows:

Designation of Tax Matters Partner (see the instructions)
Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶	**T.M. Partner**	Identifying number of TMP ▶	**493-44-8927**
Address of designated TMP ▶	**497 Milky Way** **Universal City, CA 23227**		

The designation can also be made for any tax year by filing a statement with the IRS Service Center where the partnership return was filed.

Selection of a New TMP

The partners should choose a new TMP for a partnership tax year in any of the following situations:

1. The designated TMP has chosen a successor.
2. All general partners at the end of the year for which the designation was made are:
   a. dead, liquidated, or dissolved.
   b. incompetent (as determined by a court).
   c. no longer partners in the partnership.
3. All partnership items of the partners who were general partners at the end of the tax year for which the designation was made have become nonpartnership items (for example, in the case of bankruptcy).

If the new TMP is chosen as a successor by the existing TMP, the existing TMP must file with the IRS a signed written statement to that effect. If the new TMP is chosen under item 2 or 3, the partnership must file with the IRS a written statement signed by partners holding more than 50% of the partnership profits interests at the partnership's tax year-end. The method for filing these statements is detailed in Reg. 301.6231(a)(7)-1.

Revocation of TMP Designation

The TMP designation can be revoked by general partners owning more than 50% of the general partner profits interests (or, if all general partners are described by items 2 or 3 of "Selection of a New TMP," by any partner group owning more than 50% of the profits interests).

Resignation of TMP

A designated TMP can resign at any time by filing a written statement with the IRS Service Center where the partnership return was filed for the designation year.

Merger or Termination

IRS Chief Counsel has twice ruled in Chief Counsel Advice (CCA) that the IRS had the right to select a new TMP in the case of a merger. In CCA 200245002, the IRS held that it had the right to select a new TMP where a corporate partner designated by a limited liability company as its TMP was terminated due to a merger. In CCA 200250012, the IRS also decided it had the right to appoint a TMP where one of two partners in a partnership terminated because of a merger and the other one was liquidated. In that case, the IRS appointed the parent corporation of the former partner as the TMP.

TMP under Criminal Investigation

The mere fact that a TMP is under criminal investigation does not automatically terminate the TMP's designation. However, a TMP under criminal investigation may have different interests than the rest of the partners. Thus, the other partners should consider designating a new TMP to better represent their interests with the IRS.

Termination of TMP Designation

The partner's TMP designation is terminated if any of the following events occur:

1. The TMP dies or becomes incompetent (as determined by a court).
2. The TMP liquidates or is dissolved.
3. All partnership items of the TMP become nonpartnership items (as in a bankruptcy proceeding).
4. The TMP resigns or appoints a successor TMP.
5. The partnership revokes the TMP designation or a majority of general partners appoint a new TMP.

It might be assumed the TMP duties of a former partner would be terminated when the partner withdraws from the partnership. But Reg. 301.6231(a)(7)-1(l) does not make withdrawal an event that terminates the TMP's designation. Further, in *Monetary II LP*, the 9th Circuit ruled the former partner, designated as the TMP before withdrawing from the partnership, continued to have the authority to act as TMP. Accordingly, well after withdrawal from the partnership, the former partner made what turned out to be a binding agreement to extend the statute of limitations for a prior-year partnership return. When a TMP withdraws from the partnership for any reason, the partnership should affirmatively designate a new TMP. This action clearly terminates the former TMP status.

According to the IRS, a partner's successor-in-interest as the result of a corporate merger has the authority to extend the statute of limitations for the entire partnership. In ILM 200245002, the IRS concluded that the successors-in-interest were the appropriate parties with an interest in the partnership adjustments, and that the new partner had assumed the rights and responsibilities of the merged partner. Thus, the new partner, arising from the merger, was entitled to execute the statute extension.

Who Is TMP When the Partnership Has Not Made a Designation?

If the partnership does not designate a TMP for any tax year, or if the designation is terminated under any of the circumstances outlined in items 1 through 5 under "Termination of TMP Designation" and the partnership does not designate a new TMP, the IRS has a general rule to determine the TMP. This rule provides that the general partner with the largest profits interest at the end of the partnership tax year for which the designation is made is the TMP. If more than one general partner is designated under this rule, the general partner whose name would appear first in an alphabetical listing is the TMP. The IRS can ignore the largest profits interest rule and appoint a nondesignated partner as the TMP in the following circumstances:

- It is not apparent from the Schedules K-1 which partner has the largest profits interest. In this case, any general partner may be designated as the TMP by the IRS.

- Each general partner has no profits interest in the partnership. The IRS can select any general or limited partner to serve as the TMP. The IRS can consider such factors as the partner's familiarity with the records, the partner's knowledge of partnership operations, and the views of the majority interest partners.

- The general partner with the largest profits interest is suspended from practice before the IRS, is imprisoned, resides outside of the U.S. and its territories and possessions, cannot be located, or cannot perform the TMP function. If no other general partner qualifies, the IRS can select any general or limited partner to serve as the TMP. The IRS can consider, in its TMP selection, factors such as the partner's familiarity with the records, the partner's knowledge of partnership operations, and the views of the majority interest partners.

The IRS must notify both the selected TMP and the partnership of their selection of the TMP. Furthermore, the partnership must be notified if the IRS intends to ignore the largest profits interest rule. The partnership then has 30 days from the date of the notice to select a TMP under the usual rules. However, at any time after this rule goes into effect, the partners can designate a new TMP using one of the methods described previously under "How to Make the TMP Designation" or "Selection of a New TMP."

The IRS must notify all of the partners whose name, address and profit-sharing percentage appear on the tax return for the year under examination of the selected TMP's name and address where the IRS designates a TMP.

Example 4A-1 Determining a new TMP upon bankruptcy of existing TMP.

Jerry Jinx organized a tax shelter partnership in 1995. The partnership, Threeferone Partners, had three general partners, Jerry Jinx, Johnny Jinx, and Bonanza Company, and each owned 1% of partnership profits, losses, and cash flow. Jerry was the designated TMP for each of the partnership's tax years. In late 2010, Jerry received a notice that the partnership's 2007 income tax return had been selected for audit, and since the statute of limitations would expire on 4/15/11, the IRS requested an extension of the statute of limitations.

Jerry extended the statute for the partnership through 4/15/12. On 1/1/11, Jerry filed for personal bankruptcy. Reg. 301.6231(c)-7 provides that a partner's bankruptcy converts all partnership items of the partner to nonpartnership items on the date the petition for bankruptcy is filed. The partnership items affected are all those arising in partnership tax years through the latest tax year of the partner.

Accordingly, Jerry Jinx's TMP designation is terminated for all partnership tax years on 1/1/11. Since Johnny Jinx and Bonanza Company each own 1% of partnership profits, the new TMP, by default, is the general partner whose name occurs first in an alphabetical listing. Therefore, Bonanza Company is the new TMP. At any time after 1/1/11, the partners can designate another TMP by filing a written statement with the IRS. The statement must be signed either by partners owning more than 50% of partnership profits or general partners owning more than 50% of general partner profits interests (that is, both Johnny and Bonanza).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following is a restriction on who a partnership can designate as its tax matters partner (TMP)?

    a. The TMP must be, at a minimum, a limited partner in the partnership.

    b. The TMP must have been a partner for at least five years.

    c. A TMP designation is valid until the partnership officially revokes it.

    d. Generally, the Commissioner's consent is needed to designate a TMP who is not a U.S. citizen.

32. Which of the following statements regarding the termination of a TMP is most accurate?

    a. A TMP will be automatically terminated if under criminal investigation.

    b. Once a TMP withdraws from the partnership, the TMP's duties are not necessarily terminated.

    c. In the event of a corporate merger, a successor-in-interest must be designated by the partnership.

33. The Failsafe Partnership did not designate a TMP for its 2010 tax year. For this tax year, George Adams received $500,000 in profits interest from the partnership; Jean Blythe received $1 million; Rafe Caroll received $750,000; and Lucy Desmond received $500,000. Which partner will the IRS designate as the Failsafe TMP for this tax year?

    a. George.

    b. Jean.

    c. Rafe.

    d. Lucy.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Which of the following is a restriction on who a partnership can designate as its tax matters partner (TMP)? **(Page 209)**

    a. The TMP must be, at a minimum, a limited partner in the partnership. [This answer is incorrect. With certain restrictions, a partnership can designate any *general partner* as the TMP. A general partner is publicly known, actively engages in management of the partnership's business, and participates in the partnership's profits and losses to the fullest extent. A limited partner is merely an investor in the partnership.]

    b. The TMP must have been a partner for at least five years. [This answer is incorrect. The TMP must have been a partner at some time during the tax year for which the designation is made or must be a partner at the time the designation is made. There are no other year-limit restrictions for TMPs.]

    c. A TMP designation is valid until the partnership officially revokes it. [This answer is incorrect. The partnership must designate a TMP each year. The designation generally is made by completing the section on Page 3 of Form 1065 titled "Designation of Tax Matters Partner."]

    d. Generally, the Commissioner's consent is needed to designate a TMP who is not a U.S. citizen. [This answer is correct. A partner who is not a U.S. citizen or resident, a domestic partnership, a domestic corporation, or a U.S. estate or trust cannot be designated as the TMP without the Commissioner's consent.]

32. Which of the following statements regarding the termination of a TMP is most accurate? **(Page 211)**

    a. A TMP will be automatically terminated if under criminal investigation. [This answer is incorrect. If a TMP is under criminal investigation, the partners should consider designating a new TMP to better represent their interests with the IRS. However, it is not grounds for automatic termination.]

    b. Once a TMP withdraws from the partnership, the TMP's duties are not necessarily terminated. [This answer is correct. According to Reg. 301.6231(a)(7)-1(l), the withdrawal is not considered an event that terminates the TMP's designation. In *Monetary II LP*, the 9th Circuit ruled the former partner, designated as the TMP before withdrawing from the partnership, continued to have the authority to act as TMP. Accordingly, well after withdrawal from the partnership, the former partner made what turned out to be a binding agreement to extend the statute of limitations for a prior-year partnership return.]

    c. In the event of a corporate merger, a successor-in-interest must be designated by the partnership. [This answer is incorrect. According to the IRS, a partner's successor-in-interest as the result of a corporate merger has the authority to extend the statute of limitations for the entire partnership. In ILM 200245002, the IRS concluded that the successors-in-interest were the appropriate parties with an interest in the partnership adjustments, and that the new partner had assumed the rights and responsibilities of the merged partner.]

33. The Failsafe Partnership did not designate a TMP for its 2010 tax year. For this tax year, George Adams received $500,000 in profits interest from the partnership; Jean Blythe received $1 million; Rafe Caroll received $750,000; and Lucy Desmond received $500,000. Which partner will the IRS designate as the Failsafe TMP for this tax year? **(Page 211)**

   a. George. [This answer is incorrect. If more than one partner qualified as TMP under the IRS's general rule, the IRS would select the partner whose name appeared first in an alphabetic listing. If George appeared on this listing, he would be TMP because his last name starts with "A."]

   b. Jean. [This answer is correct. If the partnership does not designate a TMP for any tax year, or if the designation is terminated and the partnership does not designate a new TMP, the IRS has a general rule to determine the TMP. This rule provides that the general partner with the largest profits interest at the end of the partnership tax year for which the designation is made is the TMP. In this scenario, Jean would be the TMP because she earned the largest amount of income from the partnership.]

   c. Rafe. [This answer is incorrect. Rafe would not qualify as the TMP under either the IRS's general rule or the list the IRS uses when the general rule returns a list of more than one partner. However, there are three instances in which the IRS can ignore the general rule and appoint a nondesignated partner as the TMP. One of those instances is if each general partner has no profits interest in the partnership. Were that the case, it is possible that the IRS might select Rafe as the TMP.]

   d. Lucy. [This answer is incorrect. Lucy would not qualify as the TMP under either the IRS's general rule or the list the IRS uses when the general rule returns a list of more than one partner. There are three circumstances under which the IRS can ignore the general rule and appoint a nondesignated partner as the TMP. One of those instances is if the general partner that would be designated under the general rule is suspended fro practice before the IRS, is imprisoned, resides outside the U.S and its territories and possessions, cannot be located, or cannot perform the TMP function. Were one of those circumstances true, it is possible that the IRS might select Lucy as the TMP.]

The Identification of Partnership and Nonpartnership Items

The determination of whether any item is a partnership or nonpartnership item is very important. Partnership items are audited and adjusted only in partnership-level proceedings. Additionally, partners are required to report partnership items in the same manner as the partnership does on its return.

What Is a Partnership Item?

Generally, any item that is more appropriately determined at the partnership level than at the partner level is a partnership item. See Reg. 301.6231(a)(3)-1 for a list of partnership items. The question of whether a partner is really a partner in the partnership appears to be a partnership item. In *Blonien*, the Tax Court found that a partner's claim that he was not a partner would affect the income or loss of the other partners. Further, Reg. 301.6233-1(b) requires that a determination that no partnership exists must be made in a partnership proceeding. Thus, determination of partner status is a partnership item. However, even if it is not a partnership item, the IRS will still have one year to make an assessment, since the determination of "partner" status will be an affected item under IRC Sec. 6229(d)(2).

Concluding that a partner's at-risk basis was not anything that a partnership reports, the Court of Federal Claims held that the determination of a partner's at-risk basis is a nonpartnership item that cannot be determined in a partnership proceeding. Conversely, the application of the anti-abuse rules of Reg. 1.701-2 to a partnership covered by the consolidated partnership audit procedures is treated as a partnership item determined at the partnership level. Of course, any affected items will be raised at the partner level.

When Does a Partnership Item Become a Nonpartnership Item?

Under certain circumstances, a partnership item may become a nonpartnership item, such as when—

1. The partner files Form 8082 and notifies the IRS he has treated partnership items differently from the partnership's treatment.
2. The partner files for bankruptcy or goes into receivership.
3. The partner does not receive proper notice of the beginning or end of a partnership audit.
4. The partner enters into a settlement agreement with the IRS.

Several other circumstances causing partnership items to become nonpartnership items are listed in IRC Sec. 6231(b) and in the regulations under IRC Sec. 6231(c).

Correcting Schedule K-1 Information with Form 8082 Disclosure

Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request) is used to notify the IRS of a taxpayer's inconsistent treatment of a partnership item. (Form 8082 is also used to file an amended partnership return.) Inconsistent treatment occurs when a partner does not treat a pass-through item the way it was reported on the Schedule K-1. Inconsistent treatment can involve a difference in amount, timing, or characterization of an item. For example, if a Schedule K-1 reports a partner received an allocation of investment interest expense, but the interest is properly characterized as trade or business interest on the partner's individual return, the partner should file Form 8082 to report the different characterization of the item.

Form 8082 should be filed under the following circumstances:

1. The Schedule K-1 is incorrect.
2. The partnership has not filed a tax return or issued the partner a Schedule K-1 by the time the partner files his income tax return.
3. The partner files an amended return to change the treatment of a pass-through item previously reported by the partnership.

A partner does *not* have to file Form 8082 to report a loss, deduction, or credit that is not reported on his return because the amount is otherwise limited—such as a loss limited due to lack of basis or the application of the at-risk or passive loss rules.

If a partner is reporting an inconsistency in the current year, Form 8082 should be completed and filed with the partner's current year return. (If the partner is filing an amended return, Form 8082 must be filed with the amended return *and* a separate copy of Form 8082 must be filed with the IRS Service Center where the partnership files its returns.) If a partner reports a partnership item inconsistently with the partnership's treatment of the item and does not file Form 8082, the IRS can impose the 20% negligence penalty on any resulting underpayment.

Example 4B-1 Filing Form 8082 to report inconsistent treatment.

Abby Rhodes, a partner in Apple Partners, received a Schedule K-1 reporting a $10,000 partnership capital loss. Abby reports a $10,000 ordinary loss on Schedule E of her Form 1040 because she believes her Schedule K-1 is incorrect. Since Abby reported the partnership items inconsistently with her Schedule K-1, she should file Form 8082 to indicate the treatment of these items is inconsistent.

If Abby fails to file Form 8082, the IRS matching program will likely catch the inconsistency, recalculate her tax liability, and assess applicable penalties.

Filing Form 8082 precludes the IRS from assessing tax on any computational adjustment the IRS might make to conform Abby's treatment of the partnership loss to the treatment reported on Schedule K-1. If Abby files Form 8082 and the IRS subsequently wishes to examine the nature of the partnership loss, it can either (1) conduct a partnership-level audit, or (2) notify Abby that all partnership items reported in her return will be treated as nonpartnership items and audit Abby's return.

Special Rules for Tiered Ownership Structures

Special consistency rules apply to tiered ownership structures. A partner who owns an interest in a partnership (the upper tier) owning an interest in another partnership (the lower tier) complies with the consistency rules if:

1. The partner in the upper tier reports partnership items consistently with the treatment of such items by the lower tier.

2. The partner in the upper tier does not report partnership items consistently with the treatment of such items by the lower tier, but files Form 8082 explaining the inconsistency.

3. The partner in the upper tier reports partnership items consistently with the treatment of such items by the upper tier, which is consistent with such treatment by the lower tier.

4. The partner in the upper tier reports partnership items consistently with the treatment of such items by the upper tier, and the upper tier has filed Form 8082 reporting inconsistent treatment with the treatment of such items by the lower tier.

These tiered ownership rules can create problems for the practitioner when preparing returns for a partner in the upper-tier entity. How does the practitioner know that the treatment of an item on the Schedule K-1 from the upper tier is consistent with the treatment of that item by the lower tier? How does the practitioner know if the upper-tier entity filed Form 8082? This once again highlights the problems created for the practitioner by the lack of useful information provided on Schedule K-1.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Would the question of partnership status be considered a partnership item or a nonpartnership item?

    a. Partnership item.

    b. Nonpartnership item.

35. Under what circumstances would a partnership item become a nonpartnership item?

    a. The partnership did not file a tax return.

    b. The partner's Schedule K-1 is incorrect.

    c. The partner does not report a limited loss on his return.

    d. The partner files for bankruptcy.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Would the question of partnership status be considered a partnership item or a nonpartnership item? **(Page 216)**

    a. Partnership item. [This answer is correct. The question of whether a partner is really a partner in the partnership appears to be a partnership item. In *Blonien*, the Tax Court found that a partner's claim that he was not a partner would affect the income or loss of the other partners. Further, Reg. 301.6233-1(b) requires that a determination that no partnership exists must be made in a partnership proceeding. Thus, determination of partner status is a partnership item.]

    b. Nonpartnership item. [This answer is incorrect. Determination of partner status appears to be a partnership item. If partnership status were later determined to be a partnership item, the IRS will still have one year to make an assessment, since the determination of "partner" status will be an affected item under IRC Sec. 6229(d)(2).]

35. Under what circumstances would a partnership item become a nonpartnership item? **(Page 216)**

    a. The partnership did not file a tax return. [This answer is incorrect. If a partnership has not filed a tax return or issued the partner a Schedule K-1 by the time the partner files his income tax return, a Form 8082 (Notice of Inconsistent Treatment or Administrative Adjustment Request) should be filed.]

    b. The partner's Schedule K-1 is incorrect. [This answer is incorrect. This is an example of an instance when a Form 8082 needs to be filed.]

    c. The partner does not report a limited loss on his return. [This answer is incorrect. This is not a case of a partnership item becoming a nonpartnership item, nor is it a case of needing to file a Form 8082. A partner does not have to file a Form 8082 to report a loss, deduction, or credit that is not reported on his return because the amount is otherwise limited.]

    d. The partner files for bankruptcy. [This answer is correct. Under certain circumstances, a partnership item may become a nonpartnership item. Examples of this include when (1) the partner files for bankruptcy or goes into receivership, (2) the partner does not receive proper notice of the beginning or end of a partnership audit, or (3) the partner enters into a settlement agreement with the IRS.]

An Administrative Adjustment Request

It is not quite as easy for a partnership to file an amended return as it is for an individual or a corporation. This is understandable since an amended partnership return impacts the returns of all of its partners. In fact, the amendment of a partnership return is not even called an amended return—it is called an administrative adjustment request (AAR). The AAR is a *request* to be allowed to adjust the partnership return.

Form 8082 Is Used to Request Adjustment

An AAR is filed by completing Form 8082 [Notice of Inconsistent Treatment or Amended Return (Administrative Adjustment Request)]. An AAR can be filed at any time before the expiration of the statute of limitations and before a Final Partnership Administrative Adjustment (FPAA) is mailed to the TMP for that year. The AAR can be filed by the TMP on behalf of the partnership or by any other partner on his or her own behalf.

In *Samueli* the Tax Court agreed that an amended return filed for a partner on Form 1040X without a Form 8082 could be treated as a partner AAR. However, it must substantially comply with Reg. 301.6227(d)-1, which requires:

1. Duplicate filing with the original copy filed with the partner's amended income tax return and the service center where the partnership return is filed,

2. Identification of the partner and the partnership by name, address and taxpayer identification number,

3. Specification of the partnership tax year to which the AAR applies,

4. That it relate only to partnership items; and

5. That it relate only to one partnership and one partnership tax year.

Substituted Return (on Behalf of All Partners)

If the TMP files the AAR on behalf of the partnership, he can request the AAR be treated as a substituted return. This treatment is the most similar to what practitioners normally think of as an amended return. A substituted return AAR is typically filed when the partnership is reporting an increase in taxable income or is reporting an increase or decrease in taxable income resulting from a mathematical or clerical error. If the IRS agrees to treat the AAR as a substituted return, the treatment of partnership items on the AAR is substituted for the treatment of such items on the original partnership return. The IRS treats the substituted return as a correction of a mathematical or clerical error and mails a notice of clerical or mathematical error correction to each partner.

Example 4C-1 Request by TMP for substituted return.

Bill and Ted are equal general partners in Adventure Travel Partners (ATP). Bill is the designated TMP. ATP's tax adviser, George, discovers Bill and Ted deducted $20,000 of expenses in the 2010 partnership return that should have been capitalized as preopening expenses. They ask George to file a substituted return for 2010. George fills out Form 8082. He checks the box on Line 2 of Part I indicating that it is a substituted return. In Part II, George describes the changed amount on Line 10 as "Form 1065 Schedule K, Line 2, Net income (loss) from rental real estate activities." He checks the box in Column (b) showing this is a change in the amount of an item. Column (c) shows the original amount reported, and Column (d) shows the amount now reported. The difference shown in Column (e) is $20,000.

George attaches an "amended" partnership return to the completed Form 8082 but does not enter any amounts on the return. He writes across the top margin of Form 1065, "See attached Form 8082 for AAR per IRC Sec. 6227(c)(1)." George then completes Schedules K-1 for Bill and Ted showing the amended amounts for each partner. Bill, as the TMP, must sign the amended return.

AAR Not Treated as a Substituted Return

A TMP can file an AAR that is not treated as a substituted return (a "claim for refund" AAR) on behalf of the partnership or a partner can file a claim for refund AAR on his or her own behalf. This type of AAR is used to report a reduction in partnership income and generate a refund to the partners. The IRS has several options for responding to the AAR (IRC Sec. 6227).

If the AAR is filed on behalf of the partnership by the TMP, the IRS can:

1. Allow credits or make refunds with respect to any or all of the changes requested (i.e., treat the AAR as, in effect, a substituted return).

2. Conduct a partnership-level audit.

3. Take no action.

If the AAR is filed by a partner on his or her behalf, the IRS can:

1. Process the request as if it were a claim for refund or credit based on a nonpartnership item.

2. Assess any additional tax resulting from the requested change.

3. Mail a notice to the partner that all partnership items for the year in question will now be treated as nonpartnership items and resolved at the partner level.

4. Conduct a partnership-level audit.

It seems safe to assume if a partner files an AAR resulting in an increase in taxes, the IRS will accept the request and assess the additional tax. However, this may trigger a partnership-level audit.

Example 4C-2 AAR filed by partner other than TMP.

Assuming the same facts as in Example 4C-1, suppose that after the error is discovered Bill and Ted do not agree the expenses are preopening expenses. Bill believes the expenses were properly deductible, but Ted thinks the expenses should be capitalized. Ted can file a Form 8082 to request adjustment of his share of partnership items. If a partner files an AAR, it must be filed in duplicate. The original copy is filed with the partner's amended income tax return. The other copy is filed with the IRS Service Center where the partnership return is filed.

What Happens If AAR Is Denied by IRS?

If the IRS disallows all or a part of an administrative adjustment request, the TMP or the other partner filing the AAR has limited recourse.

1. If the AAR was filed by the TMP on behalf of the partnership, the TMP can file a petition for adjustment with the Tax Court, the District Court, or the Claims Court. The petition cannot be filed until six months after the date the AAR was filed, but it must be filed within two years of that date.

2. If the TMP or another partner files an AAR on his own behalf and the IRS notifies the partner that all partnership items for the tax year in question will be treated as nonpartnership items, the AAR is treated as a claim for refund. The partner can file suite for refund within two years after the mailing of the IRS notice.

3. If the TMP or another partner files an AAR on his own behalf, and the IRS disallows the requested adjustment but does not notify the partner that partnership items have been reclassified as nonpartnership items, the partner can sue for refund in a civil action. When the civil action begins, all partnership items are automatically reclassified as nonpartnership items. The action cannot begin until six months after the AAR is filed but must begin within two years of that date.

The Statute of Limitations for Partnership Items

Generally, the statute of limitations for partnership items extends three years from the later of (1) the date on which the partnership return is due (without extensions)—for example, April 15 for calendar-year returns, or (2) the date on which the partnership return is filed.

The rules outlined in this lesson do not apply to small partnerships exempt from the TEFRA consolidated partnership audit procedures. The statute of limitations runs separately for each partner in such a partnership and generally extends three years from the later of (1) the date on which the partner's income tax return is due (without extensions)—for example, April 15 for calendar-year individuals, or (2) the date on which the partner actually filed an income tax return. Partnerships exempt from TEFRA consolidated procedures are those that have 10 or fewer partners at all times during the tax year. (For this purpose, a taxpayer and spouse and their estates are considered one partner.) In addition, all of the partners must be individuals (other than nonresident aliens), estates, or C corporations. The determination of the partnership's status as a small partnership is made annually. Such small partnerships may elect to be subject to TEFRA consolidated audit procedures. The election is effective for all future years and is revocable only with IRS consent.

Relationship of Individual and Partnership Statute of Limitations

The statute of limitations on partnership items is governed by IRC Sec. 6229. At least one court has held that IRC Sec. 6229 means the period for assessing a tax attributable to a partnership item will not expire before three years after the partnership return was due or filed, whichever is later.

Fraud

The statute of limitations never expires for partnership items with respect to which a partner has (with the intent to evade tax) signed or participated directly or indirectly in the preparation of a return which includes false or fraudulent items. When the partner did not participate in the fraud, his statute of limitations to report partnership income or loss from a fraudulent return is extended from three years to six years.

Substantial Understatement

If a partnership reports income that is understated by more than 25%, the statute of limitations is extended from three to six years.

No Return Filed

If a partnership fails to file an income tax return, the statute for that year never expires.

Partnership Items Become Nonpartnership Items

If partnership items become nonpartnership items before the regular statute expires (or any agreed-upon extensions of the statute), the statute is automatically extended until one year after the partnership items become nonpartnership items. The statute for assessing additional tax remains open until the last partnership item is resolved. Thus, settling some items earlier than others does not limit the period for assessing tax on those settled items.

Even if an item is not a partnership item, an extended statute of limitations may apply. For example, in *Estate of Robert W. Quick*, the Tax Court held that the determination of whether the taxpayers materially participated in an activity was an affected item which, although determined at the individual partner level, still was covered by IRC Sec. 6229(d). Thus, the IRS had until one year after the partnership determination became final to issue a notice of deficiency to the taxpayers. Reg. 301.6231(a)(5)-1 now provides the same result. The application of IRC Sec. 469 to a partner is an affected item to the extent it is not a partnership item.

Extension of Statute

As frequently happens, if the IRS wishes to audit a partnership and the statute period is running out, the agent will ask for an extension of the statute of limitations. It is generally in everyone's best interest to agree to the extension, since the IRS's alternative is to issue a deficiency notice. Remember, the TMP can agree to an extension of the statute that binds all the other partners.

Consent to extend the time to assess tax attributable to partnership items can be signed by the TMP or other person authorized in writing by the partnership to do so. Form 872-P (Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership) is a fixed-period consent, while Form 872-O (Special Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership) is an open-ended consent. Form 872-O can be terminated by (1) the partnership filing Form 872-N (Notice of Termination of Special Consent to Extend the Time to Assess Tax Attributable to Items of a Partnership) with the IRS; (2) the IRS mailing Form 872-N to the partnership; or (3) the IRS mailing a Notice of Final Partnership Administrative Adjustment (FPAA), which is the partnership equivalent of a Notice of Deficiency, to the partnership.

Many practitioners avoid open-ended consents because they can leave the partner unnecessarily exposed to an assessment if not properly terminated. The fixed period consent provides a clear cutoff of the partner's liability for assessment, and a second consent can be executed if warranted by the circumstances. And although the practitioner may be authorized by a power of attorney to extend the statute of limitations, it is far better for the client to do so to avoid a claim that the practitioner actually lacked the authority to sign the consent.

The danger of extending the statute indefinitely is illustrated by the *Silverman* case. There, even though a limited partner executed a closing agreement, the Court ruled that the IRS assessment made more than one year after the closing agreement was still valid. The IRS had assessed the additional tax within 90 days of the filing of Form 872-T (Notice of Termination of Special Consent to Extend the Time to Assess Tax), as required. Accordingly, the open-ended extension of the statute overrode the one-year provision in the closing agreement.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Generally, when should a TMP file an administrative adjustment request (AAR) as a substituted return?

    a. When the partnership reports income that is understated by more than 25%.

    b. When the partner is reporting an inconsistency in the current year.

    c. When the partnership is reporting an increase in taxable income.

    d. When the partner in the upper tier reports partnership items consistently with the treatment of such items by the lower tier.

37. Jorge, a partner with JGV, files an AAR on his own behalf. Juan Carlos, the TMP for JGV, files an AAR on behalf of the partnership. What action by the IRS is applicable to both of these scenarios?

    a. Take no action.

    b. Conduct a partnership-level audit.

    c. Assess any additional tax resulting from the requested change.

    d. Process the request as if it were a claim for refund or credit based on a nonpartnership item.

38. The Meyer & Sons partnership filed a tax return that included false and fraudulent items. John Meyer, the TMP, directly participated in the preparation of this return and signed it, knowing that it was fraudulent. His sons, Karl and Luke, did not participate in the fraud. What statute of limitations applies to Karl and Luke?

    a. One year.

    b. Three years.

    c. Six years.

    d. The statute of limitations never expires.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

36. Generally, when should a TMP file an administrative adjustment request (AAR) as a substituted return? **(Page 221)**

    a. When the partnership reports income that is understated by more than 25%. [This answer is incorrect. If a partnership reports income that is understated by more than 25%, the statute of limitations is extended from three to six years.]

    b. When the partner is reporting an inconsistency in the current year. [This answer is incorrect. If a partner is reporting an inconsistency in the current year, Form 8082 should be completed and filed with the partner's current year return.]

    c. When the partnership is reporting an increase in taxable income. [This answer is correct. If the TMP files the AAR on behalf of the partnership, he can request the AAR be treated as a substituted return. This treatment is the most similar to what practitioners normally think of as an amended return. A substituted return AAR is typically filed when the partnership is reporting an increase in taxable income or is reporting an increase or decrease in taxable income resulting from a mathematical or clerical error.]

    d. When the partner in the upper tier reports partnership items consistently with the treatment of such items by the lower tier. [This answer is incorrect. Special consistency rules apply to tiered ownership structures. A partner who owns an interest in a partnership (the upper tier) owning an interest in another partnership (the lower tier), is considered to comply with the consistency rules when the partner in the upper tier reports partnership items consistently with the treatment of such items by the lower tier.]

37. Jorge, a partner with JGV, files an AAR on his own behalf. Juan Carlos, the TMP for JGV, files an AAR on behalf of the partnership. What action by the IRS is applicable to both of these scenarios? **(Page 221)**

    a. Take no action. [This answer is incorrect. The IRS can take no action if the AAR is filed on behalf of the partnership by the TMP. However, this is not the case if the AAR if filed by a partner on his or her behalf.]

    b. Conduct a partnership-level audit. [This answer is correct. A partnership-level audit could be conducted when the AAR is filed on behalf of the partnership by the TMP and also when the AAR is filed by a partner on his or her behalf. It seems safe to assume that if a partner files an AAR resulting in an increase in taxes, the IRS will accept the request and assess the additional tax. However, this may trigger a partnership-level audit.]

    c. Assess any additional tax resulting from the requested change. [This answer is incorrect. Assessing additional tax resulting from a requested change is only performed by the IRS if the AAR is filed by a partner on his or her behalf.]

    d. Process the request as if it were a claim for refund or credit based on a nonpartnership item. [This answer is incorrect. The IRS can only process the request as if it were a claim for refund or credit based on a nonpartnership item if the AAR is filed by a partner on his or her behalf.]

38. The Meyer & Sons partnership filed a tax return that included false and fraudulent items. John Meyer, the TMP, directly participated in the preparation of this return and signed it, knowing that it was fraudulent. His sons, Karl and Luke, did not participate in the fraud. What statute of limitations applies to Karl and Luke? **(Page 223)**

   a. One year. [This answer is incorrect. If partnership items become nonpartnership items before the regular statue expires (or any agreed-upon extensions of the statute), the statute is automatically extended until one year after the partnership items become nonpartnership items. However, this rule does not apply to the Meyer & Sons scenario.]

   b. Three years. [This answer is incorrect. Generally, the statute of limitations for partnership items extends three years from the later of (1) the date on which the partnership return is due (without exceptions) or (2) the date on which the partnership return is filed. However, because fraud is involved, a different statute of limitations will apply in to Luke and Karl in this situation.]

   c. Six years. [This answer is correct. Because Luke and Karl did not participate in the fraud, their statute of limitations to report partnership income or loss from the fraudulent return will be extended from three years to six years.]

   d. The statute of limitations never expires. [This answer is incorrect. The statute of limitations never expires for partnership items with respect to which a partner has (with intent to evade tax) signed or participated directly or indirectly in the preparation of a return which includes false or fraudulent items. This statute of limitations will apply to John in this scenario.]

Avoiding Penalties by Relying on Tax Advisers

In most situations, partners are relatively unfamiliar with the details of the partnership's business. Typically, the partners also rely on the general partner or a managing partner to select competent tax advisers and tax return preparers. Absent specific knowledge of the details of the partnership's business and of specific knowledge of the competence and integrity of the partnership's tax advisers and return preparers, partners should be able to assert the reasonable cause/good faith defense if the IRS attempts to impose the substantial understatement penalty because of partnership items. This is especially true if the partner also relied on his own presumably competent tax adviser. However, if the partner's personal tax adviser made inquiries and informed the partner the partnership was taking a questionable tax position, the partner probably would not be able to assert a reasonable cause/good faith defense.

Where the IRS is imposing penalties on partners, one question is whether the partner can raise a partner-level reasonable cause and good faith exception in the partnership proceeding. Where a partner has no management role (as would be the case with a limited partner or non-participating member), the partner is not permitted to raise an individual defense of reasonable cause and good faith in the partnership tax case. In this situation, the partner can request a refund of the penalty through a refund suit, but that is obviously an expensive and time-consuming option. However, in *Stobie Creek Investments, LLC* the Court of Federal Claims declined to combine a partner-level refund claim with a partnership proceeding, which is not a refund action.

To avoid the requirements imposed on written advice (covered opinions) by Circular 230, Sec. 10.35, many practitioners include a disclaimer that the advice cannot be relied on to avoid penalties on the client. Where that disclaimer exists, the client will likely not be able to utilize the reasonable cause exception. Of course, if the practitioner does not include the disclaimer, then the advice must meet the covered opinion rules of Circular 230, Sec. 10.35. See *PPC's Dealing with the IRS* for a discussion of the covered opinion rules.

Example 4E-1 Reliance on tax adviser's advice to demonstrate reasonable cause.

John Taylor is a partner in the Castle, Smith, Johnston, & Taylor Management Consultants Partnership. The partnership has contracted with Fred Crow, CPA, to provide tax preparation and consultation services. Crow prepared the partnership's return for calendar year 2010 which included a deduction that may produce a *substantial understatement* on Taylor's personal income tax return if the deduction is disallowed by the IRS. Crow is a competent tax adviser and has thoroughly researched the issue. He has requested, and the partnership has provided, all information relevant to this issue.

Taylor is involved in the partnership's marketing operations and has minimal knowledge of its financial and tax dealings. He uses Joe Peck, CPA, as his personal tax accountant. Peck is also a competent tax adviser and has worked with Crow in obtaining information relative to the partnership's operations for tax planning sessions with Taylor. Peck is aware of the partnership's tax return position and concurs with Crow's research and position. He has informed Taylor of the situation.

Taylor, while not an individual directly involved with his partnership's financial and tax operations, has used the services of competent tax advisers at both the partnership and personal return level. The partnership can demonstrate it acted in good faith (which is imputed to Taylor) in claiming a deduction for the item. Taylor's own actions in using a competent tax adviser who has reviewed the findings of the partnership's tax accountant, concurred, and discussed the facts with him have done nothing to negate this determination of good faith. Thus, Taylor can demonstrate reasonable cause and in good faith with respect to the deduction, even if he had not employed Peck (because the partnership itself seems to have met the tests).

Form 1065 Preparer Penalties

The 2007 Small Business and Work Opportunity Act and the 2008 Extenders Act (a) increased the amount of the Section 6694 preparer penalty; (b) changed the standards for imposing a penalty; and (c) expanded the penalty to cover estate and gift tax, employment tax, exempt organization, and excise tax returns. The more-likely-than-not standard is stricter than the substantial authority and reasonable basis standards.

In late 2008, Treasury issued an extensive set of final regulations under IRC Sec. 6694. The final regulations, which apply to returns and claims for refund filed and advice provided after 2008, do not provide substantive guidance on the amendments made to IRC Sec. 6694 by the 2008 Extenders Act [i.e., the replacement of the more-likely-than-not standard (i.e., a greater than 50% likelihood of being upheld) with substantial authority]. Rather, the Treasury Department reserved Reg. 1.6694-2(c) for this purpose and issued Notice 2009-5 to provide interim guidance on the amendments and Rev. Proc. 2009-11 to identify the returns subject to a penalty under IRC Sec. 6694.

Understanding the Basic and Increased Preparer Penalties

Basic Penalty—Understatement Due to Unreasonable Position. Following changes by Congress in 2007 and 2008, a practitioner who prepares a tax return that has an understatement of tax due to an unreasonable position and who knew or should have known about the position is liable for a penalty under IRC Sec. 6694(a) equal to the greater of $1,000 or 50% of the income derived or to be derived from preparing the return. A position is unreasonable unless there was substantial authority for the position, as defined in Reg. 1.6662-4(d), or the position was properly disclosed and had a reasonable basis as defined in Reg. 1.6662-3(b)(3). However, the prior more-likely-than-not standard continues to apply to tax shelters and reportable transactions.

The underlying Committee Report to the 2008 Extenders Act says that the substantial authority standard conforms the return preparer standard to the taxpayer standard. Therefore, substantial authority under IRC Sec. 6694 should be similar to substantial authority under IRC Sec. 6662.

Increased Penalty—Willful or Reckless Conduct. IRC Sec. 6694(b) imposes an increased penalty on the preparer of a return or refund claim with a tax understatement due to willful or reckless conduct. The increased willful or reckless conduct penalty is the greater of $5,000 or 50% of the income derived or to be derived from the return preparation. However, this penalty is reduced by the penalty paid by the preparer under IRC Sec. 6694(a) for an unreasonable position. Willful or reckless conduct includes a willful attempt to understate the tax liability on the return or claim, or a reckless or intentional disregard of the rules or regulations.

The final regulations retain the good faith, reasonable cause exception, meaning that a practitioner can get an abatement of a preparer penalty if he or she has office procedures in place that promote accuracy and consistency in return preparation. The office procedures will generally include checklists, methods for obtaining necessary information from the taxpayer, a review of the prior year's return, and other review procedures.

Who Is a *Preparer*?

According to Reg. 301.7701-15(a), a tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of a return or claim for refund. However, the final regulations differentiate *signing preparers* from *nonsigning preparers*. A *signing preparer* has primary responsibility for the overall substantive accuracy of the tax return or claim for refund. A *nonsigning preparer* is not a signing tax return preparer, but prepares all or a substantial portion of the return or claim for refund "with respect to events that have occurred at the time the advice is rendered" (e.g., an accountant who provides advice to a corporate taxpayer on a completed corporate transaction).

There is only one individual within a firm who is primarily responsible for each position on the return giving rise to an understatement. In identifying the individual who is primarily responsible for the position, the IRS may advise multiple practitioners within the firm that it may conclude one of them is the primarily responsible individual. In some circumstances, there may be more than one tax return preparer who is primarily responsible for the position(s) if multiple tax return preparers are employed by, or associated with, different firms.

The signing tax return preparer [within the meaning of Reg. 301.7701-15(b)(1)] generally will be considered the person who is primarily responsible for all positions on the return giving rise to an understatement. If there is no signing tax return preparer or the IRS concludes that the signing tax return preparer is not primarily responsible for the position, the nonsigning tax return preparer [within the meaning of Reg. 301.7701-15(b)(2)] within the firm with overall supervisory responsibility for the position(s) giving rise to the understatement generally will be considered the tax return preparer for Section 6694 purposes.

To the extent provided in Regs. 1.6694-2(a)(2) and 1.6694-3(a)(2), an individual and his or her firm, or the firm of which the individual is a partner, member, shareholder, or other equity holder, can both be subject to a penalty for position(s) on the return giving rise to an understatement. If an individual (other than the sole proprietor) who is employed by a sole proprietorship is subject to a penalty under IRC Sec. 6694, the sole proprietorship is considered to be the firm for these purposes.

The preparer definitions are important because the regulations use a position-by-position penalty analysis, which replaces the one-return-one-preparer rule. When more than one position results in an understatement, more than one penalty can be assessed, making it possible for multiple penalties to be assessed for a single return, particularly when nonsigning preparers are responsible for positions on the tax return.

Any return preparer, except a signing preparer, who prepares all or a substantial portion of a tax return for compensation, with respect to completed events, is a nonsigning preparer and can be subject to the penalty. This definition leaves a huge gap—advice on prospective transactions does not make a practitioner a nonsigning preparer. To be subject to a preparer penalty, the advice or other consultation must occur after the event or events have already occurred. Additionally, the nonsigning preparer must be responsible, at a minimum, for one or more positions that constitute a substantial portion of the return. Whether a position is a substantial portion of a return is determined by the facts and circumstances. Thus, a single, large capital gain for which a nonsigning preparer is responsible can constitute a substantial portion of a return and subject that nonsigning preparer to a penalty if there is an understatement attributable to the capital gain.

For nonsigning preparers only, a position is not considered a substantial portion on a return if it is (1) less than $10,000 or (2) less than $400,000 and also less than 20% of the gross income shown on the return or refund claim. (For an individual, the income measure is AGI.) When a nonsigning preparer handles more than one position, all positions are aggregated to see whether the income threshold is met.

Exposure to Multiple Preparer Penalties from Pass-through Entity Returns

In the 1992 *Goulding* decision, an attorney was determined to be the preparer of three research and development partnership returns *and* of 533 limited partner returns—even though he had no contact with these limited partners. He was assessed $53,300 in Section 6694(a) penalties—at the old-law rate of $100 per return. The same year, in *Adler and Drobny, Ltd. v. U.S*, the District Court held the partnership item amounts were *substantial*, but because the individual partners' returns were complex, the partnership items did not constitute a *substantial portion* of the partners' returns. However, on appeal the 7th Circuit stated the complexity of the partnership return and the tax impact of the partnership loss on the individual investors should have been examined, and so remanded the case to the District Court to reapply the *substantiality* test.

According to Reg. 301.7701-15(b)(3), the preparer of one return is not considered to be the preparer of another return merely because an entry or entries reported on the first return may affect an entry reported on the other return, unless the entry or entries reported on the first return are directly reflected on the other return and constitute a substantial portion of the other return. The regulations specifically state that the preparer of a partnership return is considered the preparer of a partner's return if the entry or entries on the partnership return reportable on the partner's return constitute a substantial portion of the partner's return. Factors to consider in determining whether a portion of the return is "substantial" include (but are not limited to) the size and complexity of the position or item in question compared with the partner's gross income, and the size of the understatement at issue compared to the partner's reported liability.

Meeting the Reliance Exception

The final regulations retain the basic rule that a preparer can rely, without further verification, on information provided by clients. But as before, the preparer cannot ignore the implications of information received from clients, and must make further inquiries if the information appears to be incomplete, inconsistent, or inaccurate. When the Code requires additional substantiation, as in IRC Sec. 274, the preparer must ask whether the client has it.

The preparer can also rely on information furnished by other practitioners or advisors or, for that matter, any third party, subject to the limitation that the practitioner must make inquiries if the information appears inconsistent, inaccurate, outdated, or incomplete. Likewise, a preparer can rely on a previously filed return, although the preparer must confirm that there have been no audit adjustments or amendments to the return.

Under Reg. 1.6694-2(e)(5), a preparer is not considered to have relied in good faith on a third party if—

1. The advice or information is unreasonable on its face;

2. The preparer knew, or should have known, that the other party providing the advice or information was not aware of all relevant facts; or

3. The preparer knew or should have known, given the nature of his or her practice, that the advice, information, administrative or industry practice was no longer reliable at the time the return or refund claim was prepared due to developments in the law or IRS administrative practice since the time the advice was given.

Example 4F-1 Reliance on another preparer's work to avoid the $1,000 or 50% of fee penalty.

Lon Gere, CPA, prepares Lacey Sheet's 2009 Form 1040. Included in Lacey's tax information is a Schedule K-1 from Bogus Films, Ltd.—a limited partnership. The Schedule K-1 shows a 2009 loss of $100,000. From his client write-up work for Lacey, Lon knows she did not invest any money in the partnership and she does not have any additional records regarding the partnership interest. Nevertheless, Lon does not investigate the Schedule K-1's correctness by consulting his client or attempting to contact the preparer of the Bogus Films partnership return. Lon is subject to the Section 6694(a) preparer penalty for unrealistic tax positions. He did nothing to establish a reasonable cause/good faith defense based on reliance on another preparer (i.e., the preparer of the partnership return and Lacey's Schedule K-1). In fact, Lon may be subject to the increased Section 6694(b) preparer penalty for willful understatement of Lacey's tax liability.

Example 4F-2 Reliance on another preparer's work to avoid the $5,000 or 50% of fee penalty.

Assume the same facts as in Example 4F-1, except Lon is familiar with the tax positions taken in the Bogus Films partnership return. He knows the $100,000 loss shown on Lacey's Schedule K-1 is based on several tax positions that are contrary to federal tax rules or regulations. Nevertheless, Lon includes the $100,000 loss in Lacey's return without a reasonable basis or adequate disclosure. In this situation, Lon is exposed to the Section 6694(b) greater of $5,000 or 50% of the return preparation fee penalty for tax positions contrary to rules or regulations. There is no reasonable cause/good faith defense against this penalty, so there is no way to even argue Lon based the deduction on reliance on the work of another preparer.

The final regulations also permit good faith reliance on generally accepted industry or administrative practices in determining whether a position has substantial authority.

Meeting the Adequate Disclosure Exception

Signing preparers can avoid the Section 6694(a) penalty if the position has a reasonable basis and is adequately disclosed. According to Reg. 1.6694-2(d)(3), adequate disclosure occurs if Form 8275 (Disclosure Statement) or Form 8275-R (Regulation Disclosure Statement) is filed, or if disclosure is made in accordance with the annual revenue procedure described in Reg. 1.6662-4(f)(2). Signing preparers can also make adequate disclosure for returns that are subject to penalties under IRC Sec. 6662 [other than the accuracy-related penalty for a substantial understatement of income tax under IRC Sec. 6662(b)(2) and (d)] by advising the taxpayer of the penalty standards under IRC Sec. 6662, and contemporaneously documenting the advice in the files.

According to Reg. 1.6694-2(d)(3), nonsigning preparers also can make a disclosure on a properly completed Form 8275 or 8275-R, or on the return in accordance with the annual revenue procedure described in Reg. 1.6662-4(f)(2). Further, except for tax shelters or reportable transactions, the penalty will not apply if the nonsigning preparer advises the client of the opportunity to avoid penalties under IRC Sec. 6662, if relevant, and of the disclosure requirements to avoid the penalties. Similarly, if the advice is given to another preparer and has a reasonable basis, again except for tax shelter or reportable transactions, adequate disclosure will occur if the other preparer is advised that disclosure under IRC Sec. 6694 may be required. In either case, the advice must be contemporaneously documented in writing in the nonsigning preparer's file.

Importance of Due Diligence

The preparer penalty regulations stress documentation, communication with clients, and most of all, due diligence. Preparers will be expected to exercise appropriate due diligence in all tax return preparation tasks. Even if the answer is wrong, a preparer who acts in good faith, asks appropriate questions, does the necessary research, and documents what has been done should not be assessed a preparer penalty.

Conflicts between Taxpayer and Preparer Penalty Rules

When conflicts arise between the two sets of penalties, the preparer has several alternatives, with some being more attractive than others:

1. When there is no substantial authority, the preparer must disclose the position or be subject to the preparer penalty.

2. When the preparer must disclose to avoid the penalty but the client directs the preparer not to disclose, the preparer can disclose, thereby avoiding a preparer penalty but inviting a malpractice claim.

3. The preparer can withdraw from the engagement.

While there are no hard and fast rules to guide practitioners, the following should be considered:

1. Whether the client's attitude (or lack of integrity) could affect other issues.

2. Whether the current problem is part of a pattern of conduct by the client.

3. Whether the client understands the issue, acts out of emotion rather than reason, or possesses incorrect or incomplete information.

4. Whether the client's position can be slightly changed, thereby meeting one of the penalty standards without substantially affecting the amount of tax owed.

5. Whether the risk of the penalty is worth the client's continued business.

The Penalty for Failure to File Form 1065

A penalty is imposed on the partnership, rather than the partners, for failure to file a timely or complete Form 1065. The penalty is assessed for each month (or fraction of a month) of the failure—not to exceed 12 months—for an amount equal to $195 per partner per month for returns required to be filed for tax years beginning after 12/31/09.

Example 4H-1 Penalty for failure to file partnership return.

The Quick Bucks Limited Partnership was formed in May 2000 with two general partners and 38 limited partners and has a calendar year end. On 4/15/11, the managing general partner failed to file an extension request for the 2010 return. Since the 2010 return was not timely filed, the partnership (not the partners) is liable for a failure to file penalty of $7,800 [(40 partners × $195)] per month unless there was reasonable cause for the failure to file.

As with the other penalties, showing reasonable cause for the failure to timely file or complete the partnership Form 1065 will avoid the penalty. In one case, the District Court held that reliance on an outside accountant did not constitute reasonable cause for the failure to file and pay withholding amounts in a timely manner: "It requires no special training or effort to ascertain a deadline and make sure that it is met. The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing" under IRC Sec. 6651(a)(1).

Rev. Proc. 84-35 provides another exception for domestic partnerships with 10 or fewer C corporation or individual partners (other than nonresident aliens), if they have properly reported their shares of income, deductions, credits, etc., on their respective income tax returns. In a Service Center Advice, the IRS indicated it will abate the failure to file penalty if, upon receipt of the notice of the penalty, all partners sign the notice, including their full names and taxpayer identification numbers, and answer "Yes" to the following questions:

1. Is the partnership a domestic partnership?

2. Does the partnership have 10 or fewer partners? (Spouses and their estates are treated as one partner.)

3. Are all partners natural persons (other than a nonresident alien) or an estate of a deceased partner?

4. Is each partner's share of each partnership item the same as his or her share of every other item?

5. Have all the partners timely filed their income tax returns?

6. Have all the partners fully reported their share of the income, deductions, and credits of the partnership on a timely filed income tax return?

Reg. 301.7502-1 provides that a return postmarked by the due date is timely filed even if received after the due date. However, the return must be properly addressed and mailed with sufficient postage, if U.S. mail is used. If a private carrier is used, the postmark must be legible, made on or before the due date of the return, properly addressed, and received on or before the date the return would ordinarily be received if delivered by the U.S. Postal Service. Under Reg. 301.7502-1(d), electronically transmitted documents are deemed to be timely filed if the electronic postmark is given by the electronic return submitter.

Tax returns or other documents will be treated as timely filed if delivered to (or picked up by) a designated private delivery service on or before the due date of the return or document. In Notice 2004-83, the IRS provided the latest list of private delivery services. The notice also specifies which delivery services of these carriers qualify. Only the delivery services listed in the notice qualify for the *timely mailed is timely filed* exception. Generally, the notice provides that the date the item is electronically recorded in the service's data base or marked on the cover of the item is the *postmark date*. However, there is a presumption that the *postmark* date is the day that precedes the delivery date by an amount of time it would normally take for an item to be delivered under the terms of the delivery service used. This presumption may be overcome by showing that the delivery date is on or before the due date.

Extensions for Filing a Partnership Return

Under Temp. Reg. 1.6081-2T, which is effective for returns due after 12/31/08, partnerships file Form 7004 (Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns) to request an automatic five-month extension of time to file Form 1065. This means that the extended due date for a partnership return with a calendar year end is September 15.

It can be expensive for a partnership to miss filing an extension. IRC Sec. 6698 imposes a $195 per month per partner penalty for not filing a timely tax return. In addition, missing the filing deadline can preclude a partnership from extending the contribution date for retirement plan contributions as well as limit the partnership's ability to make various elections that are required to be made on a timely filed return, including any extensions. While a partnership can get the failure to file penalties abated for reasonable cause, it is often much more difficult to get relief for missed elections (see Lesson 3).

The regulations also provide the IRS the authority to terminate the automatic extension of a partnership (as well as that of a trust, REMIC, or individual) at any time by mailing a notice of termination at least 10 days prior to the termination date designated in the notice. The termination notice must be mailed to the address shown on the automatic extension form or to the taxpayer's last known address.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. The preparer penalty regulations place the greatest importance on which of the following elements of tax return preparation?

    a. Documentation.

    b. Communication with clients.

    c. Due diligence.

40. The Oops Partnership fails to timely file its Form 1065 by its filing deadline of December 2010 and does not file for an extension. The partnership files the form in April 2011, and the failure to file penalty is assessed. The partnership has 30 partners during the 2010 tax year. Calculate the penalty amount that the Oops Partnership must pay.

    a. $195 will be assessed to each partner in the partnership.

    b. $195 will be assessed to the partnership.

    c. $5,850 will be assessed to the partnership.

    d. $23,400 will be assessed to the partnership.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

39. The preparer penalty regulations place the greatest importance on which of the following elements of tax return preparation? **(Page 231)**

    a. Documentation. [This answer is incorrect. Section 6694(a) stresses documentation as one important element in tax return preparation, but it is not considered the most important element in determining whether to assess a preparer penalty because the preparer penalty regulations place greater importance on another element.]

    b. Communication with clients. [This answer is incorrect. Communication with clients is another important element to be considered, as cited in Section 6694(a), when considering the possible assessment of a preparer penalty. However, the preparer penalty regulations do not consider communication with clients to be the most important element when deciding whether to assess a preparer penalty because communication with the clients is not the most effective means to preventing errors in tax return preparation.]

    c. Due diligence. [This answer is correct. Section 6694(a) preparer penalty regulations stress several elements that are important in determining whether to assess a preparer penalty. The most important element identified is due diligence. Preparers are expected to exercise appropriate due diligence in all tax return preparation tasks. Even in cases where the answer is wrong, a preparer who acts in good faith, asks appropriate questions, does the necessary research, and documents what has been done, should not be assessed a preparer penalty.]

40. The Oops Partnership fails to timely file its Form 1065 by its filing deadline of December 2010 and does not file for an extension. The partnership files the form in April 2011, and the failure to file penalty is assessed. The partnership has 30 partners during the 2010 tax year. Calculate the penalty amount that the Oops Partnership must pay. **(Page 232)**

    a. $195 will be assessed to each partner in the partnership. [This answer is incorrect. The penalty will be imposed on the partnership, not on the partners.]

    b. $195 will be assessed to the partnership. [This answer is incorrect. $195 is the base number to start calculating the failure to file penalty, but more factors must be added to the calculation.]

    c. $5,850 will be assessed to the partnership. [This answer is incorrect. This calculation is the base amount of the failure to file penalty ($195) multiplied by the number of partners in the Oops Partnership (30). However, other factors must also be taken into account to make this calculation.]

    d. $23,400 will be assessed to the partnership. [This answer is correct. The calculation of the failure to file penalty for the Oops Partnership, is performed by multiplying the base rate by the number of partners during the year (30). Then multiply the result by the number of months of failure to file (4). {[($195 × 30) × 4] = $23,400}.]

EXAMINATION FOR CPE CREDIT

Lesson 4 (T65TG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

31. List all of the following situations that would require a partnership to select a new tax matters partner (TMP).

    i. The currently designated TMP chooses a successor.
    ii. The TMP represents the partnership in unified partnership audit proceedings.
    iii. The TMP enters into a settlement agreement on behalf of the partners.
    iv. At the end of the year for which the designation was made, all the general partners are dead, liquidated, dissolved, incompetent (as determined by a court of law), or are no longer partners.
    v. All of the partnership items of partners who were general partners at the end of the tax year for which the TMP designation was made have become nonpartnership items.

    a. i. and iii.

    b. ii., iv., and v.

    c. i., iv., and v.

    d. i., ii., iii., iv., and v.

32. A TMP designation can be revoked by general partners who own more than what percent of the partnership's general partner profits interests?

    a. 25%.

    b. 50%.

    c. 75%.

    d. 100%.

33. Curly Jackson organized a tax shelter partnership in 1995. The partnership, The Three Sparks, had three general partners, Curly Jackson, Larry Jackson, and Moe Money Company, and each owned 1% of partnership profits, losses, and cash flow. Curly was the designated TMP for each of the partnership's tax years. In late 2010, Curly received a notice that the partnership's 2007 income tax return had been selected for audit, and since the statute of limitations would expire on 4/15/11, the IRS requested an extension of the statute of limitations.

    Curly extended the statute for the partnership through 4/15/12. On 1/1/11, Curly filed for personal bankruptcy. Reg. 301.6231(c)-7 provides that a partner's bankruptcy converts all partnership items of the partner to nonpartnership items on the date the petition for bankruptcy is filed. The partnership items affected are all those arising in partnership tax years through the latest tax year of the partner.

    Accordingly, Curley Jackson's TMP designation is terminated for all partnership tax years on 1/1/11. Since Larry Jackson and Moe Money Company each own 1% of partnership profits, the new TMP, by default, is which of the following?

    a. Larry Jackson.

    b. Moe Money Company.

    c. An IRS-appointed nondesignated partner.

    d. A TMP appointed by Curly Jackson.

34. What is a partnership item?

    a. Any item that is more appropriately determined at the partnership level.

    b. Any item that is more appropriately determined at the partner level.

    c. Any item that is more appropriately determined by the IRS.

    d. Any item that is more appropriately determined by the Tax Court.

35. Form 8082 should be filed when which of the following Schedules is incorrect?

    a. Schedule C.

    b. Schedule E.

    c. Schedule K.

    d. Schedule K-1.

36. Who can file an administrative adjustment request (AAR)?

    a. The partnership itself.

    b. The TMP on behalf of the partnership.

    c. Any partner on behalf of the partnership.

    d. The TMP on behalf of any partner.

37. Michael, TMP of the Banner Partnership, files an AAR on behalf of the partnership, but the IRS notifies Michael that the entire request is disallowed. What recourse does Michael have?

    a. He can file a petition for adjustment with the Claims Court, the District Court, or the Tax Court.

    b. He can file suit for refund within three years of the date the IRS mailed the notice.

    c. He can sue for refund in a civil action.

    d. He has no recourse and will have to accept the IRS's verdict.

38. If a partnership fails to file an income tax return, how is the statute of limitations affected?

    a. The statute of limitations for that tax year will remain unchanged.

    b. The statute of limitations for that tax year will be extended from three to six years.

    c. The statute of limitations for that tax year will never expire.

    d. The IRS may ask for an extension of the statute of limitations for that tax year, but it will not go into effect unless the TMP agrees.

39. If the IRS attempts to impose a penalty for substantial understatement because of partnership items, who could assert the reasonable cause/good faith defense?

    a. The TMP.

    b. A general partner.

    c. A limited partner.

    d. A partner's personal tax advisor.

40. According to Reg. 301.7701–15(a), how many individuals associated with a firm will be subject to preparer penalties with respect to a single return with an understatement of tax due to a position taken on the tax return?

    a. One member of the firm is primarily responsible for the position on the return.

    b. Any member of the firm who participated in the engagement.

    c. All members of the firm.

    d. Do not select this answer choice.

GLOSSARY

Accrual method of accounting: Partnerships using the accrual method report income when the right to receive the income has occurred and the amount can be determined with reasonable accuracy. Deductions are allowable in the year in which (1) all events necessary to establish the fact of liability or deduction have occurred, (2) the amount of the liability or deduction is determinable with reasonable accuracy, and (3) economic performance has occurred.

Administrative Adjustment Request (AAR): A request to be allowed to adjust the partnership return.

Cash method of accounting: Partnerships using the cash method of accounting report income in the year cash or property is actually or constructively received, and generally deduct expenses in the year cash or property is actually paid or transferred.

Check-the-box elections: The check-the-box regulations simplify the determination of whether an entity is taxed as a partnership or a corporation. Fundamentally, the regulations provide that a multi-owner entity is taxed as a partnership unless the entity elects to be taxed as a corporation.

Deferral period: The number of months from the end of the elected tax year forward to the end of the required year. This is used when calculating a partnership's required payment for using a year-end other than its required year-end.

Deferral ratio: The deferral period divided by 12 months. This is used when calculating a partnership's required payment for using a year-end other than its required year-end.

Economic performance: Generally, economic performance occurs when property or services are provided to (or by) a third party. It is important to the accrual method of accounting.

Electing large partnership: In general, an electing large partnership is defined as a partnership with 100 or more partners in the preceding partnership tax year that elects to be treated as a large partnership. IRC Secs. 771 through 777 simplify filing requirements for electing large partnerships. The electing large partnership rules, if elected, will prevail over the ordinary partnership rules.

General partner: A party who is publicly known and who actively engages in the management of the business and participates to the fullest extent in the profits and losses of the partnership. A general partner has apparent and actual authority to bind the partnership and has joint and several liability.

Least aggregate deferral of income rule: The third level of hierarchy for determining a partnership's required year. If neither the majority interest rule nor the principal partners rule applies, the partnership must select a tax year resulting in the least aggregate deferral of income to the partners.

Limited partner: A party who is merely an investor in a partnership. The party's liability is limited to the capital contribution to the partnership. Like a corporate shareholder, a limited partner does not participate in the management of the business.

Majority interest rule: The first level of hierarchy for determining a partnership's required year. The partnership must adopt the tax year of the partners who own, in the aggregate, more than 50% of the capital and profits interest.

Minority interest rule: This rule provides that the tax years of foreign partners are not disregarded under IRC Sec. 706(b) if no single partner (other than a disregarded foreign partner) holds a 10% or greater interest in the capital or profits of the partnership, and if, in the aggregate, the partners that are not disregarded foreign partners do not hold a 20% or greater interest in the capital or profits of the partnership.

Nonaccrual experience method of accounting: This is a hybrid accrual method where amounts received for the performance of services are not included in income, if based on experience, they will not be collected. This method is available only for amounts received for the performance of qualified services and for services provided by certain small businesses. Qualified services are services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting. The availability of this method is conditioned on the taxpayer not charging interest or a penalty for failure to timely pay the amount charged.

Nonconforming tax year: A partnership can adopt a nonconforming tax year if certain exceptions to the required year rules apply (e.g., a Section 444 election).

Nonpartnership item: Under certain circumstances (e.g., the partner files for bankruptcy or enters into a settlement agreement with the IRS), partnership items can become nonpartnership items.

Partnership: A form of business in which two or more persons join their money and skills in conducting the business as co-owners. Partnerships are treated as a conduit and are not subject to taxation. Various items of partnership income, expenses, gains, and losses flow through to the individual partners and are reported on their personal income tax returns.

Partnership item: Any item more appropriately determined at the partnership level than at the partner level.

Principal partners rule: The second level of hierarchy for determining a partnership's required year. If no partner, or combination of partners, owning more than 50% of the profits and capital interests has the same tax year, the partnership tax year must be the same as that of the principal partners. Principal partners are those owning 5% or more in either profits or capital interests.

Qualified spousal joint venture: Under the Small business and Work Opportunity Tax Act of 2007 (SBWOTA), this is any joint venture involving the conduct of a trade or business if (1) the only members of the joint venture are a husband and wife, (2) both spouses materially participate in such trade or business, and (3) both spouses elect not to be treated as a partnership. If the spouses elect for the joint venture not to be treated as a partnership, all items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture,

Required year: The partnership must use its required year unless certain circumstances apply (e.g., the business purpose exception or a Section 444 election). Even if it is not used, certain rules and limitations drive off of the required year.

Section 444 election: Under IRC Sec. 444, partnerships can elect to adopt, change, or retain tax year-ends other than required year-ends. This election is made by filing Form 8716 (Election to Have a Tax Year Other Than a Required Tax Year) by the earlier of (1) the 15th day of the fifth month following the month that includes the first day of the tax year for which the election will first be effective, or (2) the due date, without extensions, of the income tax return for the first year resulting from the Section 444 election.

Tax Matters Partner (TMP): Every partnership is required to have a TMP. The TMP is responsible for representing the partnership in unified partnership audit proceedings. The TMP receives the audit notification, conducts the audit, and enters into a settlement agreement on behalf of the partners.

INDEX

A

ADEQUATE DISCLOSURE
- To avoid preparer penalties 228

ADMINISTRATIVE ADJUSTMENT REQUEST (AAR)
- Amended return 221
- Disallowance by IRS 221
- Form 8082 221
- Not treated as a substituted return 221
- Substituted return (on behalf of all partners) 221

AMENDED RETURNS
- Administrative adjustment request 221
- Filing requirements 232
- Substituted return 221

AUDIT OF PARTNERSHIP
- Administrative adjustment request (AAR) 221
- Extending the statute of limitations 222
- Nonpartnership item 216
- Partnership item 216

C

CHECK-THE-BOX
- Election 187
- Foreign eligible entity 187
- Late filings 187

CIRCULAR 230
- Disclaimer for written advice 228

COVERED OPINION RULES
- Disclaimer for written advice 228

D

DEFINITION OF TERMS
- Electing large partnership 198
- Husband-wife qualified joint venture 188
- Partnership 188

DUE DILIGENCE IN PREPARING PARTNERSHIP RETURNS
- In general 228

E

ELECTING LARGE PARTNERSHIP
- Computation of income 198
- Election 198
- In general 198
- Limitations 198
- Reporting 198
- Specially treated items 198
- Termination of 198

ELECTING OUT OF PARTNERSHIP TAX RULES
- Failure to elect out 188
- How to elect out
  - Blank Form 1065 method 188
  - Facts and circumstances method 188
- Husband-wife businesses 188
- Investment property 188
- Joint operating agreement 188
- Rental real property 188
- Spousal joint ventures 187
- When not to elect out 188

ELECTIONS
- Electing large partnership 198
- Entity classification 187
- Husband-wife businesses 188
- Out of partnership tax rules 188

EXTENSION OF TIME
- Filing returns 233
- Statute of limitations 222

F

FILING INSTRUCTIONS
- Designated private delivery services 232
- "Timely mailing" as "timely filing" rule 232

FORM 8082
- Correcting Schedule K-1 information 216
- Filing form, when necessary 216
- Inconsistent treatment
  - Tiered ownership, special rules 216
- Requesting administration adjustment 221

FRAUD
- Statute of limitations 222

H

HUSBAND-WIFE BUSINESS
- Community property states 188
- Electing out of partnership status 188
- Qualified joint ventures 188
- Self-employment tax implications 188

I

INVESTMENT ACTIVITY
- Election out of partnership tax rules 188

J

JOINT OPERATING AGREEMENT
- Electing out of partnership tax rules 188

N

NONPARTNERSHIP ITEM 216

P

PARTNERSHIP
- Definition 187

PARTNERSHIP ITEM
- Conversion to nonpartnership item 216
- Definition of 216
- Statute of limitations 222

PENALTIES
- Conflicts between taxpayer penalty rules and preparer penalty rules 232
- Disclosure to avoid penalties 228
- Excessive claim for refund or credit 228
- Failure to file 232
- Preparer penalties
  - Adequate disclosure exception 228
  - Defenses against 228
  - Definition of preparer 228
  - Disclosure to avoid 228
  - Due diligence 228
  - Multiple preparer penalties, exposure to
    - Pass-through entity return 228
  - Pass-through entity 228
  - Pass-through entity return 228
  - Reliance exception, meeting the 228
  - Understatement due to unreasonable position 228
  - Willful or reckless conduct 228
- Reliance on tax adviser 228
- Reliance on third-party preparer 228

R

RENTAL REAL PROPERTY
- Electing out of partnership tax rules 188
- Husband-wife qualified joint ventures 188

S

STATUTE OF LIMITATIONS
- Extension of 222
- Fraud 222
- No return filed 222
- Partnership items become nonpartnership items 222
- Partnership items, of 222
- Relationship between individual and partnership statute of limitations 222
- Substantial understatement 222

SUBCHAPTER K
- Electing out of 188

SUBSTANTIAL UNDERSTATEMENT
- Statute of limitations 222

T

TAX MATTERS PARTNER (TMP)
- Amended returns, role of TMP 221
- Appointment of by IRS 209
- Bankruptcy of existing TMP 209
- Default selection 209
- Designation of 209
- Resignation of 209
- Revoking designation of 209
- Selection of new one 209
- Termination of designation 209

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1065 Deskbook—Course 1—Basis and Allocations (T65TG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   T65TG101 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

	Page
CPE Examination Questions (Lesson 1)	**71**
CPE Examination Questions (Lesson 2)	**123**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1065 Deskbook—Course 1—Basis and Allocations (T65TG101)

CTEC Course No. 3039-CE-0256
Price $79

First Name: ______________________________

Last Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________ State /ZIP: ______________

Firm Phone: ______________________________

Firm Fax No.: ______________________________

Firm Email: ______________________________

Express Grading Requested: ☐ Add $24.95

CTEC No.: ______________________________

Signature: ______________________________

Credit Card Number: ______________________ Expiration Date: ______________

Birth Month: ______________________ Licensing State: ______________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	14.	○	○	○	○	27.	○	○	○	○	39.	○	○	○	○
2.	○	○	○	○	15.	○	○	○	○	28.	○	○	○	○	40.	○	○	○	○
3.	○	○	○	○	16.	○	○	○	○	29.	○	○	○	○	41.	○	○	○	○
4.	○	○	○	○	17.	○	○	○	○	30.	○	○	○	○	42.	○	○	○	○
5.	○	○	○	○	18.	○	○	○	○	31.	○	○	○	○	43.	○	○	○	○
6.	○	○	○	○	19.	○	○	○	○	32.	○	○	○	○	44.	○	○	○	○
7.	○	○	○	○	20.	○	○	○	○	33.	○	○	○	○	45.	○	○	○	○
8.	○	○	○	○	21.	○	○	○	○	34.	○	○	○	○	46.	○	○	○	○
9.	○	○	○	○	22.	○	○	○	○	35.	○	○	○	○	47.	○	○	○	○
10.	○	○	○	○	23.	○	○	○	○	36.	○	○	○	○	48.	○	○	○	○
11.	○	○	○	○	24.	○	○	○	○	37.	○	○	○	○	49.	○	○	○	○
12.	○	○	○	○	25.	○	○	○	○	38.	○	○	○	○	50.	○	○	○	○
13.	○	○	○	○	26.	○	○	○	○										

You may complete the exam online by logging onto our online grading system at **cl.thomsonreuters.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: November 30, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1065 Deskbook—Course 1—Basis and Allocations Course Acronym: T65TG101

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
	Low (1) . . . to . . . High (10)									
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's 1065 Deskbook—Course 2—Administrative Matters (T65TG102)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **cl.thomsonreuters.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   T65TG102 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

	Page
CPE Examination Questions (Lesson 1)	**155**
CPE Examination Questions (Lesson 2)	**184**
CPE Examination Questions (Lesson 3)	**206**
CPE Examination Questions (Lesson 4)	**237**

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's 1065 Deskbook—Course 2—Administrative Matters (T65TG102)

CTEC Course No. 3039-CE-0257
Price $79

First Name: ____________________

Last Name: ____________________

Firm Name: ____________________

Firm Address: ____________________

City: ____________________ State /ZIP: ____________________

Firm Phone: ____________________

Firm Fax No.: ____________________

Firm Email: ____________________

Express Grading Requested: ☐ Add $24.95

CTEC No.: ____________________

Signature: ____________________

Credit Card Number: ____________________ Expiration Date: ____________________

Birth Month: ____________________ Licensing State: ____________________

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ✓.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **cl.thomsonreuters.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: November 30, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's 1065 Deskbook—Course 2—Administrative Matters Course Acronym: T65TG102

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

(Low (1) . . . to . . . High (10))

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

For more information on our CPE & Training solutions, visit cl.thomsonreuters.com. Comments may be quoted or paraphrased for marketing purposes, including first initial, last name, and city/state, if provided. If you prefer we do not publish your name, write in "no" and initial here ________