Partnership Operations and Distributions

Steven M. Friedman
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# PARTNERSHIP OPERATIONS AND DISTRIBUTIONS

By

STEVEN M. FRIEDMAN

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PARTNERSHIP OPERATIONS AND DISTRIBUTIONS

By

STEVEN M. FRIEDMAN

I. Introduction.

A. Operative theories: The partnership rules of Subchapter K/l reflect the inherent tension between the aggregate and entity theories of taxation. As an entity, a partnership must satisfy a number of compliance rules and consider various reporting requirements. However, in true aggregate fashion, the tax attributes resulting from partnership operations typically flow through unchanged to the partners. The tension between these theories, as to which should control, in many instances is the primary source of confusion in partnership taxation.

B. Flexibility: Irrespective of this fundamental tension, the partnership remains the most flexible entity ownership vehicle in the Internal Revenue Code. No other entity combines the benefits of:

1. No incidence of entity level Federal tax under any circumstance;

2. Additional basis at the owner level for entity level indebtedness;

3. Freedom to make property distributions which often may be structured free of Federal income tax (although possibly at the cost of foregone basis);

4. The ability to receive current cash distributions in many cases free of tax, irrespective of the entity's earning history;

/1/ All Subchapter and section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
5. No restrictions on who may be a partner, although certain classes of partners (e.g., tax-exempt entities) may raise ancillary tax issues (such as the tax-exempt entity leasing rules); and

6. The ability to make special allocations of income or loss and disproportionate distributions among the partners.

II. Partnership Elections, Computing Partnership Taxable Income and Determining the Nature of Partnership Income To the Partners.

A. General rule: For purposes of computing and reporting income, the partnership is considered to be an entity separate and distinct from its individual members.

1. Reporting responsibility: To determine each partner's distributive share of income, the partnership is responsible for computing and reporting the income earned by the partnership. I.R.C. §§703(a) and 6031(a).

2. Liability for tax: The partnership is not a taxable entity; rather the individual partner is responsible for the tax consequences associated with his distributive share of partnership profits or losses. I.R.C. §702.

B. Elections.

1. General rule: Under section 703(b), the partnership is responsible for making all elections which may affect the computation of partnership taxable income. However, the following elections are required to be made by the individual partners:


   b. Section 617: Recapture of mining expenditures.

   c. Section 901: Foreign and U.S. possession taxes.

2. Involuntary conversion: In Demirjian v. Commissioner, 457 F.2d 1 (3rd Cir. 1972), the taxpayers were 50 percent partners in a realty partnership with an office building as the sole operating asset. Pursuant to an involuntary condemnation proceeding, the partnership sold the building and distributed the proceeds to the two taxpayers. The taxpayers elected the nonrecognition provisions of section 1033. The IRS issued a deficiency notice, arguing that for the section 1033 election to be valid, the partnership must make the election. The appellate court agreed, citing the specific language of section 703(b). See
also, Rev. Rul. 66-191, 1966-2 C.B. 300. (However, the election allowed by section 1033 has been applied at the partner level. See Ltr. Rul. 8527090 and Ltr. Rul. 8735026.)

3. Installment sales and the proportionate disallowance rule: The partnership is required to make the election under section 10202(e)(3)(A) of the Omnibus Budget Reconciliation Act of 1987 (the "1987 Act") for certain installment obligations to be excluded from the application for section 453C (before its repeal). In addition, each partner is required to attach a copy of the election and a statement to his individual tax return. Notice 88-81, 1988-30 I.R.B. 28.

C. Computing partnership taxable income.

1. General rule: Under section 703(a), a partnership generally computes income in the same manner as an individual, but with two major exceptions:

   a. Separately stated items: All items under section 702(a) are separately stated.

      i. Definition: Generally, these items are ones that "if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately." Regs. §1.702-1(a)(8)(ii). Regarding this requirement to separately state items which could affect a partner's tax liability if not separately stated, see, e.g.:

         a. Rev. Rul. 84-131, 1984-2 C.B. 37, concerning investment interest expense; and


      ii. Effect on basis: Although separately stated, these items are included in partnership taxable income for purposes of making basis adjustments. I.R.C. §705(a)(1)(A).

   b. Disallowed deductions: Certain deductions allowed to individuals are disallowed to the partnership. (Generally these are items of deduction allowed only to individual taxpayers.
or subject to special limitation on an individual's tax return.) I.R.C. §703(a)(2). These items include:

i. Personal exemptions;

ii. Charitable contributions;

iii. The net operating loss deduction;

iv. Itemized deductions allowed only to individuals under sections 211 through 219; and

v. Meal, travel and entertainment expenses paid or incurred after 1986 in partnership taxable years ending with or within the partners' taxable years beginning after 1986 (Temp. Regs. §1.702-IT); and

vi. Certain other items.

2. Item determinations: For purposes of computing income (or loss), the partnership is treated as an entity. I.R.C. §703(a). Therefore, all income and expense items are determined at the partnership level and not the partner level.

a. Example: A partner takes into account separately in his return, as long term capital gain, his distributive share of the partnership's long term capital gain from the sale of investment assets, notwithstanding that the partner's holding period for his partnership interest was not long term. Rev. Rul. 68-79. 1968-1 C.B. 310.

b. Basye v. United States, 410 U.S. 441 (1973) ("Basye"). Several doctors formed a medical partnership that performed services for a health plan (the "Plan"). The Plan paid for those services by: (1) Direct payments to the partnership; and (2) Payments to a trust it set up to hold and invest the payments. The trust funds were to be distributed to the partners and employees of the partnership upon their retirement. Individuals covered by the trust did not receive vested benefits; the amounts put in the trust were contingent and forfeitable with respect to the individual partners and employees but not to the partnership. The partnership did not include the payments to the trust in income, and the IRS issued deficiencies, claiming the payments to the trust were income to the partnership and thus taxable to the partners.
i. Lower courts: The District Court and the Ninth Circuit decided for the taxpayer, relying on the fact that the partnership never actually received the payments to the trust.

ii. Supreme Court: The Supreme Court reversed, reasoning that income must be taxed to the person who earns it. The entity earning the income (in this case a partnership) cannot divert the income to another entity (the trust).

c. The Supreme Court in Basye, supra, succinctly distinguished the entity concept of section 703 and the aggregate theory of sections 701 and 702. "For (the purpose of calculating partnership income), the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed." Basye, supra, at 448.


a. General rule: A partnership generally is free to select its own method of accounting, independent of the accounting methods used by its partners. I.R.C. §703(b).

b. Exception: Under section 448, a partnership that has one or more corporate partners or a partnership that is a "tax shelter" generally must use the accrual method of accounting. I.R.C. §448(a).

c. Exception to the exception: A partnership with $5 million or less of average annual gross receipts generally may use the cash method. I.R.C. §448(b)(3).

i. Application: The $5 million gross receipts test is an annual one, generally applied to the immediately preceding three taxable years. I.R.C. §448(b)(3).

ii. Mandatory accrual accounting: This exception to allow smaller partnerships continued availability of the cash method does not apply to "tax shelters." I.R.C. §448(b)(3). (See the discussion below.)
iii. Other accounting method rules still apply: Section 448 applies in addition to all of the other accounting method provisions contained in the Code. Thus, for example, a partnership with inventories must still use the accrual method to account for the business in which the inventories are kept.

d. "Tax shelter" defined: Section 448 uses the same definition of a tax shelter as the economic performance rules of section 461(i)(3). I.R.C. §448(d)(3).

i. Reach of the rule: A tax shelter includes:

   a. A partnership in which interests are required to be registered with any Federal or state agency having authority to regulate the offering (whether or not the offering in fact is registered);

   b. Any "syndicate," as defined in section 1256(e)(3)(B); and

   c. Any "tax shelter," within the meaning of section 6661(b)(2)(C)(ii).

ii. "Syndicate" defined: Section 1256(e)(3)(B) contains a broad definition of a syndicate. Generally, any entity in which more than 35 percent of its losses during the year are allocable to limited partners or limited entrepreneurs is a syndicate.

   a. This wording conceivably could trap a newly formed partnership which, under its agreement, allocates more than 35 percent of losses to limited partners, even if the partnership anticipates profits immediately upon commencing its business. However, the Service interprets this provision to require the partnership to incur an actual loss, rather than the theoretical possibility of one. Temp. Regs. §1.448-1T(b)(3). See, e.g., Ltr. Rul. 8753032.

   b. A limited entrepreneur is a general partner who does not actively participate in the management of the partnership. I.R.C. §464(e)(2).
D. **Nature of partnership income to the partners.**

1. **General rule:** The character of partnership income and expense generally is determined at the partnership level. I.R.C. §702(b).
   
a. **Distinguish:** Note that the character or classification of partnership income is determined at the partnership level. Whether a particular item is included in income or is deductible by the partner is determined at the partner level.
   
b. **Example:** If a partnership makes a charitable contribution, the partners are treated as making that charitable contribution. However, section 170 effectively limits the deduction for charitable contributions at the partner level and the contributions passing from the partnership to the partner are subject to limitation at that level.

2. **Gross income:** Where it is necessary to compute the gross income of a partner (e.g., in computing personal holding company income), such gross income includes the partner's distributive share of gross income from the partnership. I.R.C. §702(c).

3. **NOL character:** In determining whether losses from a partnership create a net operating loss at the partner level, the regulations provide that the partner shall take into account his distributive share of items of income, gain, loss, or credit of the partnership as if such item was realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership. Regs. §1.702-2.
   
a. **Distinguish:** Business and nonbusiness income and deductions are separately taken into account.
   
b. **Status of the partner:** No distinction is made in the regulations between general and limited partnership interests. This is significant because limited partners will be treated as receiving business income and deductions unless the income and deductions are nonbusiness at the partnership level.

E. **Reporting partnership income.**

1. **General rule:** Every partnership generally must file an information return on Form 1065 for each taxable year. The return specifically must state the items of gross income and deduction allowable under the
Code, as well as any other information required by the tax forms and the regulations. I.R.C. §6031(a).

a. When the obligation commences: The obligation to file a partnership return for a taxable year arises in the first year in which the partnership receives income or incurs any expenditures which are deductible for Federal tax purposes. Regs. §1.6031-1(a)(1).

2. Copies to partners: A Schedule K-1 must be furnished to each partner by the due date of the Federal information return (including extensions). The Schedule K-1 must show the partner's distributive share of income, gain, loss, deduction or credit. In addition, other information may be required by the form or its instructions. Prop. Regs. §1.6031-1(b).

3. Nominee reporting: A partnership must furnish a copy of Schedule K-1 and any other information required by the regulations to a nominee of any person who holds a beneficial interest in the partnership. Likewise, the nominee must furnish the information received from the partnership to the person for whom he is a nominee. I.R.C. §6031(c). In addition, the nominee must disclose to the partnership certain information regarding the person for whom he is a nominee.

a. Purpose: One goal of the nominee reporting requirements is to make compliance easier for publicly traded partnerships.

b. Administrative guidance: Temporary regulations issued on September 6, 1988 amplify and extend guidance provided earlier through Notice 87-10, 1987-1 C.B. 422, regarding the manner in which a nominee can comply with the requirements under section 6031(c)(1). Temp. Reg. §1.6031(c)-1T.

4. Penalties: A partnership that fails to timely file a return or files an incomplete return may be liable for a penalty. I.R.C. §6698(a). The penalty is $50 per partner per month for any person who was a partner in the partnership at any time during the taxable year. This penalty can be assessed for each month the partnership return is late, up to a maximum period of five months. Although nominal on its face, this penalty, if successfully assessed, can be quite expensive for the partnership. For example, a partnership with 100 partners that is four months late in filing its return may be assessed a penalty of $20,000 ($50 x 100 partners x 4 months). I.R.C. §6698(b).
III. Computation of a Partner's Distributive Share of Partnership Income.

A. Overview and historical background.

1. Statutory language.

   a. General rule: A partner's share of partnership income, gain, loss, deduction or credit is determined by the partnership agreement. I.R.C. §704(a).

      i. Form: The agreement may be either oral or written (although oral agreements may cause evidentiary problems).

      ii. Modification: Generally, the agreement between the partners can be modified.

         a. Permission: The agreement must allow modification.

         b. Timing: The amendments must be made on or before the due date (excluding extensions) of the partnership return. I.R.C. §761(c).

   b. The partner's interest in the partnership: If the partnership agreement is silent (i.e., it does not provide for an allocation), or if the purported allocation in the agreement lacks "substantial economic effect," then a partner's distributive share of profit (or loss) is determined in accordance with the "partner's interest in the partnership." I.R.C. §704(b).

2. Historical background.

   a. General rule: The substantial economic effect test found in section 704 was adopted by the Tax Reform Act of 1976 (the "1976 Act") as the sole measure for determining whether or not allocations contained in the partnership agreement would be respected.

   b. Proposed regulations: Regulations were proposed under section 704(b), as amended by the 1976 Act, on March 8, 1983. Among other things, the proposed regulations provided that:

      i. Capital accounts: Partnerships were to maintain capital accounts on a tax (rather than a fair market value) basis;
ii. Nonrecourse debt: Allocations attributable to nonrecourse debt were allowed if, among other things, the partnership agreement provided for either a "deficit restoration" or an allocation of "minimum gain"; and

iii. Contributed property: Property contributed by a partner generally was reflected in the contributing partner's capital account at its adjusted tax basis.

c. Final regulations: The proposed regulations were substantially modified by the final regulations, which were published on December 31, 1985. T.D. 8065, 1986-1 C.B. 254. The final regulations "reserved" discussion of allocations attributable to nonrecourse debt. The nonrecourse debt portion of the final section 704(b) regulations was published on September 9, 1986. T.D. 8099, 1986-2 C.B. 84.

B. The section 704(b) regulations: General considerations.

1. Effective dates.

a. Transition rule: The final regulations generally apply to partnership tax years ending after 1975. For partnership tax years beginning before May 1, 1986, allocations will be respected if they have substantial economic effect under relevant case law, the legislative history of §704(b), as amended by the 1976 Act, and certain provisions of the new regulations in effect for taxable years beginning before May 1, 1986. Regs. §1.704-1(b)(1)(ii).

b. Prospective application: The effect of the transition rule is that the final regulations were generally prospective in application from issuance and apply to tax years beginning after April 30, 1986. Calendar year partnerships, therefore, were first required to address the issue of compliance with the final regulations for the taxable year beginning January 1, 1987.

c. Nonrecourse debt: Due to their belated issuance, the nonrecourse debt provisions first applied for partnership taxable years beginning after December 31, 1986. Regs. §1.704-1(b)(1)(ii). Thus, calendar year partnerships should have addressed compliance with all provisions of the regulations for the taxable year beginning January 1, 1987. (However, for those partnerships that failed to comply, it may be possible to limit the
partners' potential risks under the subjective "partner's interest" standard only to 1987. An IRS reprieve, discussed below at C. 4. c. i. b., allows a calendar year partnership until November 1, 1988 to satisfy the initial revaluation requirement of the regulations.)

2. Satisfying the requirements of the section 704(b) regulations.
   a. General rule: In following the statutory framework, the regulations provide that, for an allocation to be recognized for tax purposes, the allocation must either:
      i. Have "substantial economic effect"; or
      ii. Be made "in accordance with the partner's interest in the partnership." Regs. §1.704-1(b)(1)(i).
   b. Default provision: If the partnership agreement provides no allocation or if the attempted allocation lacks substantial economic effect, then the partnership item is allocated according to the partner's interest in the partnership.
   c. Allocations subject to section 704(b): The provisions of the regulations apply to all allocations (not just to "special" allocations) including:
      i. "Item" allocations: A separate allocation of an item of income, gain, loss, deduction or credit (partnership "items"); and
      ii. "Bottom line" allocations: An allocation of partnership net income (or loss) to a partner is treated as an allocation to that partner of each item used in computing the partnership's "bottom line" income (or loss). Regs. §1.704-1(b)(1)(vii).
   d. Nonrecourse debt: Allocations attributable to nonrecourse debt are subject to some additional requirements. These are discussed in E., below.

3. Reviewing the partnership agreement.
   a. Timing: Because the final regulations diverge dramatically from the proposed regulations, each and every partnership existing before adoption of the final regulations should have examined its agreement in light of the final regulations. The general partner then should
have decided if (and to what extent) the partnership agreement may have needed to be amended so that any allocation would be respected.

b. Does that mean that every partnership agreement had to be amended? The answer is NO. Both the Code and the regulations provide alternative tests. If an allocation lacks "substantial economic effect," it still may be in accordance with the partner's interest in the partnership. So long as the partner's interest test is met, the partnership need not concern itself with substantial economic effect.

c. What is "the partner's interest in the partnership"?

i. Economic sharing: The partner's interest in a partnership refers to the manner in which the partners have agreed to share the economic burdens and benefits of each item of income, gain, loss or deduction. Regs. §1.704-1(b)(3)(i). Since each item is treated separately, the partners' sharing arrangement for any specific item may not match the overall economic arrangement of the partners. The regulations contain a rebuttable presumption that each partner has an equal interest in the partnership (on a per capita basis). Regs. §1.704-1(b)(3)(i).

ii. Factors: The regulations list several factors to consider (e.g., relative capital contributions and interests in cash flow). Regs. §1.704-1(b)(3)(ii). However, given the complexity of sophisticated business transactions, as a practical matter the factors many times cannot be applied with certainty.

iii. The value of partnership assets as a factor: Although the safe harbor provisions allow and at times require partnerships to revalue capital accounts, fair market value may not, in and of itself, be a factor in determining a partner's interest in a partnership. The regulations do not identify inherent value as an appropriate factor for applying the facts and circumstances test. Additionally, the Tax Court has refused to consider fair market value in determining a partner's interest in a partnership under section
704(b) prior to its amendment in 1976. In 
dicta, the court has said that the fair 
market value of assets as a factor "... 
is contrary to the principles of taxation 
that refuse to give effect to unrealized 
appreciation or loss." Young v. 

iv. "Plain vanilla" partnerships: Partnerships 
with simple capital structures (in which a 
partner has the same capital and profits 
interest and that interest does not vary 
from year to year) that do not have partner 
funded or guaranteed nonrecourse 
indebtedness should satisfy the "partner's 
interest in the partnership" test. 
Consequently, these partnerships may not 
need to amend their agreements.

C. "Substantial Economic Effect."

1. General rule: For an allocation to have "substantial 
economic effect," the allocation must have "economic 
effect" and this economic effect must be 
"substantial." Regs. §1.704-1(b)(2)(i).

2. Economic effect.

   a. General rule: An allocation of income, gain, 
      loss or deduction (but not credit) has economic 
effect if throughout the full term of the 
partnership three requirements are met. Regs. 
§1.704-1(b)(2)(ii)(b).

      i. Capital account maintenance: Partners' 
capital accounts are maintained in 
accordance with the rules found in the 
regulations (See C. 4., below);

      ii. Liquidation proceeds: Proceeds in 
liquidation must be distributed according 
to the positive capital accounts balances 
of the partners; and

      iii. Obligation to restore: Any partner with a 
deficit capital account balance following 
the liquidation of his interest in the 
partnership is unconditionally obligated to 
restore the deficit in his capital account.

     a. Limited obligation to restore: Absent 
an unconditional obligation to fully 
restore any deficit in capital, a 
partner is treated as having a limited 
obligation to restore the deficit
balance in his capital account to the extent of:

i. Any promissory note of the partner contributed to the partnership which is due and payable by the end of the partnership year in which that partner's interest is liquidated (or, if later, within 90 days of the date the interest is liquidated); or

ii. Any unconditional obligation of the partner to make additional capital contributions (within similar time constraints). Regs. §1.704-1(b)(2)(ii)(c).

b. Minimum gain chargeback: Under the nonrecourse rules (discussed at E., below), a partner's share of minimum gain is considered a limited obligation to restore a deficit in capital. Regs. §1.704-1(b)(4)(iv)(e).

b. Alternate test for economic effect -- Qualified income offset: If the first two requirements of the economic effect test, above, are satisfied, but the partners do not have an unconditional obligation to restore a deficit in capital, the allocation will still have economic effect if: (1) The allocation does not cause (or increase) a deficit in the partner's capital account (in excess of any limited dollar amount of deficit that the partner must restore); and (2) The partnership agreement contains a "qualified income offset." Regs. §1.704-1(b)(2)(ii)(c).

i. Definition: Under a qualified income offset provision, any deficit caused unexpectedly by certain special adjustments is eliminated as quickly as possible through subsequent allocations of income and gain (possibly even gross income).

ii. Future events: In determining whether or not an allocation will "cause or increase" a deficit in capital, the partner's capital account must be debited to the extent that reasonably expected post year end distributions will exceed certain offsetting future allocations of income and other credits to the partner's capital.
c. Economic equivalence test -- The "Dumb-but-lucky" rule: If the above rules are not met, an allocation will still have economic effect if the partnership agreement ensures that a liquidation of the partnership, as of the end of each partnership year, would produce the same economic results that would occur if the three requirements had been met. Regs. §1.704-1(b)(2)(ii)(i). As a practical matter, the economic effect equivalence test is not the province of the prudent tax planner. Rather, it is more like a last resort viewed with hindsight.

3. Substantiality.

a. General rule: The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts that the partners will receive from the partnership, independent of tax consequences. Notwithstanding, the economic effect of an allocation is not substantial if, at the time it becomes part of the partnership agreement:

i. Benefit: Any partner's after-tax position may, in present value terms, be improved by the allocation; and

ii. Absence of detriment: There is a "strong likelihood" that no partner's after-tax economic position (again, in present value terms) will be substantially worse as a result of the allocation. (In other words, if Treasury is the only loser, the allocation may fail this present value test.) Regs. §1.704-1(b)(2)(iii).

b. Shifting tax consequences.

i. General rule: The economic effect of an allocation is not substantial if there is a "strong likelihood" that:

a. Tax reduction: The allocation will create a net decrease in the partners' total tax liability; and

b. Minimal capital impact: The increases and decreases to capital accounts of the partners for the year (the test is an annual one) will not be much different than if the allocation had not been made. Regs. §1.704-1(b)(2)(iii)(b).
ii. "Character" allocations: This type of shifting occurs where the type of income allocated to each partner is based on a desire to minimize the partners' overall tax liabilities. For example, a dollar amount of operating income is allocated to a low-bracket partner, while an equal amount of tax-exempt interest income is allocated to a high-bracket partner. Similarly, a special allocation of section 1231 losses away from a partner with section 1231 gains with an offsetting allocation of ordinary losses to that partner would be a character allocation. Character allocations generally are not substantial.

c. Transitory allocations: Transitory allocations are not substantial. Regs. §1.704-1(b)(2)(iii)(c).

i. Definition: An allocation in one year is transitory where it will be largely offset by allocations in other years and there is a "strong likelihood" that:

a. Minimal capital impact: The partners' respective capital accounts with the allocations will not differ substantially from their capital accounts without the allocations; and

b. Tax reduction: The resulting total tax liability of the partners will be reduced.

ii. Exception -- The 5-year rule: Even if an allocation otherwise would be considered transitory, it will not be insubstantial if there is a strong likelihood that the offsetting allocation, in large part, will not be made within five years after the original allocation.

d. Value equals basis: In determining whether or not an allocation is substantial, the regulations presume that the fair market value of partnership property equals the property's adjusted tax basis. (If the book value of the property differs from its tax basis, however, the fair market value is presumed equal to the asset's book value.) Regs. §1.704-1(b)(2)(iii)(c). This presumption may prove highly significant. For example, a special allocation of depreciation coupled with
a gain chargeback provision generally should be substantial because of the "value equals basis" rule.


a. General rule: For an allocation to have economic effect, the partnership, among other things, must maintain the partners' capital accounts on a "book" basis rather than on a tax basis. Regs. §1.704-1(b)(2)(ii)(b).

Contributions and distributions of property must be reflected in capital at fair market value, rather than adjusted tax basis. This is a significant departure from the proposed regulations, which focused primarily on tax basis capital accounting.

i. Increases: A partner's capital account is increased by:

a. Money contributed to the partnership;

b. The fair market value of property so contributed, net of liabilities; and

c. Allocations of partnership income and gain.

ii. Decreases: A partner's capital account is decreased by:

a. Partnership distributions of money;

b. The fair market value of property so distributed, net of liabilities;

c. Expenditures which are nondeductible under §705(a)(2)(B) or which are syndication costs; and


b. Multiple capital accounting: For partnerships which issue audited financial statements on a GAAP basis, the above capital accounting rules will result in a third set of books that must be kept by the partnership (i.e., GAAP, tax and "book").
c. Revaluations of property.

i. Timing -- First revaluation: If a partnership existing as of April 30, 1986 wishes its agreement to have substantial economic effect, the partnership generally must revalue its capital accounts (and, therefore, its assets) for the first partnership tax year beginning after that date. Regs. §1.704-1(b)(1)(ii). Thus, calendar year partnerships which decided to comply with the regulations and revalue their partners' capital accounts must have revalued their capital accounts as of January 1, 1987. This does not mean that every asset must have been physically valued (e.g., appraised) on January 1, 1987. Rather, the value of the partnership's assets must have been established as of January 1, 1987. The valuation process may occur after that date.

a. Exception -- Differences which are not "significant": In lieu of the revaluation date, the regulations provide that a partnership existing as of that date may instead be allowed to restate capital from the date of formation of the partnership where the differences between the balance in each partner's capital account and the balance that would exist if the partnership satisfied the regulations since its inception are not significant. Regs. §1.704-1(b)(2)(iv)(r)(2). This would occur, for example, where a partnership generally has followed the capital accounting rules since inception, except that the partners' capital accounts have not been reduced for the syndication costs incurred by the partnership.


i. The conundrum of section 761(c): A calendar year partnership that failed to amend its agreement on or before April 15, 1988 to comply with the final section 704(b) regulations generally lost forever its ability to make use of the initial revaluation allowed by the regulations. This
results because section 761(c) requires that any modification of a partnership agreement must be made no later than the due date (not including extensions) of the partnership returns. Thus, for those partnerships that did not fully comply with the economic effect requirements of the regulations, it was unclear whether an amendment to the agreement in a later year coupled with an asset revaluation as of January 1, 1987 would satisfy the economic effect safe harbor.

ii. Extension of time for the initial revaluation: To give a partnership a second opportunity at the initial revaluation, the Service has extended the time for making modifications to partnership agreements to comply with the capital account revaluation rules to amendments adopted on or before November 1, 1988. Notice 88-87, 1988-34 I.R.B. 20.

iii. Practical implications: There are a number of practical implications to Notice 88-87, supra. First, the administrative extension of time until November 1, 1988 applies only to extend the time for amending an agreement so that the partnership may adopt the capital account restatement provisions of Regs. §1.704-1(b)(2)(iv)(r). The notice is not a blanket extension of time to allow a partnership to adopt all of the requisites of the economic effect safe harbor. However, it does provide an opportunity for a dilatory partnership to revalue its capital accounts as of January 1, 1987. This revaluation may create positive capital account balances for certain partners (principally limited partners) who otherwise might have impermissible deficits in capital, thus allowing the
partnership to allocate losses to them. Assuming the partnership conducts a passive activity in which these partners hold pre-enactment interests, the partnership could amend its 1987 return so that these partners currently could avail themselves of at least 65 percent of their respective shares of the partnership's losses reallocated to them. I.R.C. §469(m). (Of course, a restatement of capital accounts under no circumstance creates additional basis under section 752 for the partners. Thus, any additional losses allocated to these partners potentially will be subject to the basis limitation of section 704(d).)

ii. Timing -- Additional revaluation considerations: A partnership agreement may (but is not required to) adjust the partners' capital accounts to reflect the fair market value of all partnership property, if "made principally for a substantial nontax business purpose," upon the occurrence of any of three triggering events. Regs. §1.704-1(b)(2)(iv)(f):

a. Contribution: A contribution of money or property to the partnership by a partner for an interest in the partnership;

b. Distribution: A distribution of money or property to a partner as consideration for an interest in the partnership; or

c. "Mark to market": If GAAP is utilized and substantially all the assets of the partnership are securities and similar instruments which are readily tradable on an established market.

iii. How to revalue: The adjustments must reflect the manner in which the unrealized income, gain, loss or deduction inherent in the partnership's property would be allocated if there were a sale of the property on the date of the revaluation
(i.e., a "deemed sale" rule). Regs. §1.704-1(b)(2)(iv)(g).

iv. "Fair market value": The partners may agree among themselves to the fair market value assigned to partnership assets. The regulations presume such a valuation is correct, provided:

a. The agreed-upon value resulted from arm's length negotiations; and

b. The partners have sufficiently adverse interests. Regs. §1.704-1(b)(2)(iv)(h).

v. Fair market value on the first revaluation: Unofficially, a former Treasury official extensively involved in the regulations project has indicated that the existing partners in a partnership have sufficiently adverse interests to agree upon the value of partnership property without an appraisal. However, cautious partners may wish to use independent third party appraisers for the first revaluation. While the Service is free to challenge an appraisal, the use of a competent third party should assist the partners in defending any valuation challenge eventually raised by the IRS.

vi. Advisability of optional revaluations: In those situations in which a partnership may elect to revalue its property, it frequently will be prudent to do so. For example, where partnership property has a tax basis different from its fair market value, a revaluation would allow the capital accounts to reflect the true economic interests of the partners. Similarly, where the value of partnership assets exceeds the adjusted tax basis of the assets, a revaluation will increase the capital accounts of the partners, thus creating additional capital against which limited partners could claim their respective share of partnership losses (subject, of course, to other limitations contained in the tax laws). In other situations, however, the administrative problems may outweigh any perceived benefits.
d. Transfers of partnership interests: The capital account of a partner who transfers his (or her) interest in a partnership will normally carry over to the transferee partner. However, if there is a technical termination of the partnership within the meaning of section 708(b), the capital accounts will be adjusted as if there had been a taxable sale of the partnership's assets. Regs. §1.704-1(b)(2)(iv)(l).

e. Section 754 adjustments: Section 743(b) basis adjustments (transfers of partnership interests) generally are not reflected in capital accounts. However, section 734(b) basis adjustments (distributions of partnership property) are generally reflected in the capital account of the partner receiving the distribution or, in certain cases, in the capital accounts of all partners. Regs. §1.704-1(b)(2)(iv)(m).

D. Allocations to reflect revaluations.

1. General rule: The regulations state that the capital accounts of the partnership must be maintained on a book basis. Accordingly, for purposes of maintaining capital accounts, book depreciation and gain (or loss) with respect to revalued property must be computed on a fair market value basis, and depreciation is charged against that basis until a subsequent revaluation. This often will create a book/tax disparity. If the disparity arises due to a contribution of property, section 704(c) governs the allocation. However, if the difference arises from a revaluation of assets, capital accounts must be adjusted only for book amounts. Regs. §1.704-1(b)(4)(i). Thus, separate tax allocations cannot have economic effect and, consequently, must follow the book allocations.

E. Nonrecourse debt.

1. Partner's interest in the partnership: Allocations of loss and deduction attributable to nonrecourse debt are economically borne by the lender. Since no partner can bear this economic loss, allocations of loss and deduction attributable to nonrecourse debt cannot have substantial economic effect and these deductions must be allocated in accordance with the partners' interests in the partnership. Regs. §1.704-1(b)(4)(iv)(a).
2. Safe harbor: The regulations provide that allocations of loss and deduction attributable to nonrecourse debt are deemed to be in accordance with the partner's interest in the partnership if four requirements are met. Regs. §1.704-1(b)(4)(iv)(d):

a. Economic effect: The first two requirements of "economic effect" (discussed at C. 2. a., above) are present. Regs. §1.704-1(b)(4)(iv)(d)(1).

i. Capital account maintenance: Partners' capital accounts are maintained in accordance with the rules found in the regulations; and

ii. Liquidation proceeds: Proceeds in liquidation are distributed according to the positive capital account balances of the partners.

b. Consistency with other allocations which have substantial economic effect: The partnership agreement allocates deductions attributable to nonrecourse debt among the partners in a manner that is "reasonably consistent" with allocations (which have substantial economic effect) of some other significant partnership item attributable to the property securing the nonrecourse liability. Regs. §1.704-1(b)(4)(iv)(d)(2).

i. Example -- Inconsistent allocation of cost recovery deductions: In a two person limited partnership which owns fully leveraged depreciable property secured by nonrecourse debt, the general and limited partner share all items equally, except that 100 percent of the cost recovery deductions are allocated to the limited partner. If the cost recovery deductions are attributable to the nonrecourse debt (which in many instances they are), the allocation fails the consistency requirement.

c. Deficits in capital: The partnership agreement must provide for either: (1) The partners' unconditional obligation to restore deficits in capital (See, C. 2. a. iii., above); or (2) A minimum gain chargeback provision. Regs. §1.704-1(b)(4)(iv)(d)(3).

i. Minimum gain: In general, a partnership's minimum gain is the amount of gain realized if encumbered property is disposed of in full satisfaction of the nonrecourse
liability securing the property. Regs. §1.704-1(b)(4)(iv)(f).

ii. Minimum gain chargeback: If there is a net decrease in the partnership's minimum gain during a taxable year, all partners with a deficit capital account balance at the end of that year are allocated partnership income and gain to the extent of the decrease in the minimum gain.

a. Timing: The allocation of minimum gain under the chargeback provision operates before any other allocation of income (or loss) for the current year.

b. Deficit in capital: In determining the extent to which partners have deficit capital account balances, any amount a partner is obligated to restore is added back to their capital account, but the amount of anticipated future distributions in excess of certain offsetting increases to capital accounts will serve to increase the deficit.

d. Compliance: Aside from nonrecourse debt deductions, all other material allocations and capital adjustments must satisfy all other requirements of the final regulations. Regs. §1.704-1(b)(iv)(d)(4).

3. Nonrecourse loans by a partner: The partner who makes a nonrecourse loan to his partnership bears the burden of economic loss, rather than the partnership. Accordingly, any allocation attributable to that nonrecourse loan generally must be allocated to the lending partner. Regs. §1.704-1(b)(4)(iv)(g).

a. Guarantees: This rule applies as well to nonrecourse debt guaranteed by a partner. Thus, allocations attributable to the guaranteed portion of the nonrecourse liability must be allocated to the guarantor partner.

b. Absence of regulations integration: The existing liability sharing regulations under section 752 currently lack any provision similar to the partner-lender rules found in Regs. §1.704-1(b)(4)(iv)(g). This regulatory inconsistency may create some interesting tax anomalies for which the prudent tax practitioner
should be prepared. For example, the limited partner in a partnership composed of two C
corporations who makes a nonrecourse loan to the partnership will be allocated all deductions
attributable to that loan. However, the existing regulations under section 752 may be
read to allocate only one-half of the debt to the lending partner for basis purposes. Regs.
§1.752-1(e). Consequently, if the loan is of sufficient size and the partnership is not
profitable, at some point in time the partner will be allocated losses for which it lacks
basis, causing those losses to become suspended. I.R.C. §§704(d) and 705. The
Service and Treasury currently are at work on a revision of the section 752 regulations which,
when issued, presumably will integrate these provisions. LR-229-84.

c. Related party nonrecourse debt: The regulations "reserve" for a future date the proper treatment
of partnership nonrecourse liabilities where the lender is a person related to a partner. Regs.
§1.704-1(b)(4)(iv)(h). (When issued, it is reasonable to expect that this portion of the
section 704(b) regulations will be integrated with the liability sharing rules in the
forthcoming revision to the section 752 regulations.)

4. Multiple secured assets and multiple nonrecourse
liabilities: The regulations provide special rules
for properties securing more than one liability and
for one debt encumbering multiple assets. Regs.
§1.704-1(b)(4)(iv)(c).

a. Single asset and multiple liabilities: The
adjusted basis of an asset securing two or more
liabilities of equal priority is allocated
between the debts according to their respective
outstanding principal balances.

b. Single asset — Multiple liabilities of unequal
priority: The adjusted basis of an asset
securing two or more liabilities of unequal
priority is allocated in full first to the debt
with a priority claim. Any adjusted tax basis
of the asset remaining is then allocated to the
inferior liability.

c. Multiple assets — Single liability: If a
single nonrecourse obligation is secured by
multiple assets, the adjusted tax basis of all
of the assets is used to compute the
partnership's minimum gain, if any.
F. Other considerations.

1. Tax credits: Special allocations of credits do not have substantial economic effect because these allocations do not affect capital accounts. The investment tax credit is allocated according to the partners' profits interests. All other credits generally are allocated according to the partners' interest in the partnership. However, if the partnership expenditure which generates the credit also gives rise to allocations of loss or deduction, then the partners will share the credit in the same proportion as they share in that loss or deduction. Regs. §1.704-1(b)(4)(ii).

2. Oil and gas partnerships: The regulations contain special rules for computing depreciation, depletion and gain or loss for oil and gas properties. Regs. §1.704-1(b)(4)(v).

3. Partnership agreement amendments: For purposes of the regulations, the partnership agreement includes all agreements and amendments (whether written or oral) among the partners.
   a. Necessity of a writing: Where the partnership agreement provides that it may not be amended orally, each of the partners generally must consent in writing on a timely basis for an amendment to the agreement to be effective. Tapper v. Commissioner, 52 T.C.M. 1230 (1986).
   b. Subsequent amendments: Amendments to the agreement made subsequent to the time an allocation is made will be considered in determining whether or not prior allocations will be reallocated. In other words, the amendment may be treated as if it always was a part of the agreement. Regs. §1.704-1(b)(4)(vi).

4. Requests for a ruling: For those partnerships that wish some degree of certainty for the allocations made by their agreement, the Service has stated that it will entertain rulings on the economic effect of the allocations (but not whether those allocations are substantial). This willingness on the part of the IRS to issue a ruling extends to existing partnerships, as well as newly formed entities. Rev. Proc. 88-1, 1988-1 I.R.B. 7.

G. Contributed property.

a. General rule: The partnership takes a carryover basis in the contributed property. I.R.C. §723.

i. Distortion: A distortion in income and deduction could result between partners which could continue until the partnership is liquidated.

ii. Example 1: Individuals A and B form partnership AB. A contributes depreciable property worth $50,000 with a tax basis of $10,000. B contributes $50,000 in cash. A and B share profits and losses equally. AB takes A's basis of $10,000 in the property. A has a basis of $10,000 in his interest and B has a basis of $50,000 in her interest. If the depreciable property was sold immediately for $50,000 in year 1, and the partnership was liquidated in year 2 by distributing its $100,000 equally to A and B, the following results would occur, absent any special provisions in the Code:

a. To A: A would pick up $20,000 of gain in year 1 (his portion of the gain) and $20,000 in year 2 ($50,000 distribution less his $30,000 basis).

b. To B: B would also pick up $20,000 of gain in year 1, but she would have a $20,000 loss in year 2 ($50,000 distribution less her $70,000 basis).

c. Recognition with no "economic" gain: In this situation, B is reporting $20,000 of tax gain in year 1, when the partnership has recognized no "economic" gain. In fact, the value of B's interest has remained $50,000, despite the fact that B has reported $20,000 in gain. B, however, does report an offsetting $20,000 loss in year 2 when AB is liquidated.

iii. Prior law: Under section 704(c), as in effect prior to the 1984 Act, the partners could have provided in the partnership agreement that gain, loss, or depreciation with respect to appreciated (or depreciated) property contributed to the partnership by a partner be shared among the partners so as to take account of the variation between the income tax basis of the property and its fair market value at the time of contribution. See, I.R.C.
§704(c)(2) (as in effect prior to the 1984 Act).

a. Example 2: If the AB agreement in the above example was amended to provide for allocations to the partners to take account of the difference between the fair market value of the property and its tax basis on the date of contribution, then the $40,000 gain in year 1 would be allocable entirely to A. Upon a liquidation in year 2, each partner would receive $50,000 and neither partner would recognize gain nor loss.

b. Under section 704(c) prior to the 1984 Act amendments, the result in a., above, could be achieved only if the partnership agreement specifically provided for these allocations.

2. The 1984 Act: Mandatory allocation of "built-in" gain or loss.

a. General rule: Section 704(c), as amended by the 1984 Act, generally requires that income, gain, loss and deduction with respect to contributed property be shared among the partners to account for the variation between the basis and fair market value of the property at the time of contribution. Except as noted below, this may require property by property allocations.

i. Effect: The optional rule formerly codified in old section 704(c)(2) is now mandated as section 704(c).

ii. Reliance: Congress intended that taxpayers are entitled to rely on the regulations existing under old section 704(c)(2) until the new section 704(c) regulations are issued. H. Rep. No. 861, 98th Cong., 2d Sess. 857 (1984).

iii. Timing of deductions: Depreciation and depletion deductions generally must be allocated disproportionately to the noncontributing partner(s). See, Regs. §1.704-1(b)(2)(iv)(d)(3) and §1.704-1(b)(2)(iv)(g). This is illustrated by the example at C., below.
iv. Accrued but unpaid items: The section 704(c) regulations also are to provide that contributions by a partner using the cash method of accounting of accounts payable and other accrued but unpaid items will be subject to rules similar to those for contributions of property. See, Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Reform Act of 1984 (P.L. 98-369) (the "1984 General Explanation"), 215-216.

v. Anticipated regulations: The legislative history to the 1984 Act provides some indication of what the new section 704(c) regulations, when issued, will provide. See, e.g., 1984 General Explanation, 211-216. These regulations may ease some of the administrative burden of new section 704(c). Among the provisions which may be included are:

a. Appreciated properties: Aggregation of properties with fair market values greater than their respective basis that are contributed by a single partner.

b. Depreciated properties: Aggregation of properties with fair market values less than their respective adjusted basis that are contributed by a single partner.

c. De minimis amounts: Differences of less than 15 percent (but not exceeding $10,000) between the adjusted basis and the fair market value of any aggregated properties are to be accounted for in a manner consistent with section 704(c)(1) as it existed under prior law (i.e., to allocate items in the manner in which they would be allocated if the partnership had purchased the property for its fair market value).

d. Timing: Differences between the adjusted basis and fair market value of contributed properties are to be eliminated more slowly than otherwise required by the new rules through allocations solely of gain or loss on the disposition of such properties (thereby permitting allocations of
depreciation, depletion or similar items with respect to such property to be governed solely by section 704(b)), so long as this flexibility is not likely to result in the contributing partner avoiding the effect of the allocation of built-in gain or loss (such as when the property is expected to be held by the partners until it has little, if any, fair market value).

vi. Interplay with section 704(b): The new section 704(c) regulations take on added importance since the section 704(b) regulations generally require that section 704(c) principles be followed in making allocations to partners where the partnership's assets and capital accounts have been revalued. Regs. §1.704-1(b)(2)(iv)(f).

3. How the rules work.

a. Example: The workings of section 704(c) may be illustrated, in part, by an example.

i. Example: Cash Partner and Property Partner form an equal partnership to produce and market highly specialized equipment. Cash contributes $10,000 in cash and Property contributes depreciable property with a basis of $6,000 and a fair market value of $10,000. Profits and losses of the partnership will be shared equally. The partnership will depreciate the property on a straight line basis (assuming no salvage value) over a period of ten years for both book and tax purposes. The partnership depreciates the contributed property for two years and then sells it for $11,000 at the end of the second year.

b. The resulting allocations: The allocations for both book and tax purposes for the period of time from contribution by the partners through operation and sale are as follows:
<table>
<thead>
<tr>
<th>Contribution</th>
<th>Cash's Capital</th>
<th>Property's Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Tax</td>
<td>Book</td>
</tr>
<tr>
<td></td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Depreciation - Year 1</td>
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<td>&lt;500&gt;(1)</td>
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<td></td>
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<td>$10,000</td>
</tr>
<tr>
<td>Capital at the end of Year 1</td>
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<td>&lt;500&gt;(1)</td>
</tr>
<tr>
<td></td>
<td>$9,500</td>
<td>$9,500</td>
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<tr>
<td>Depreciation - Year 2</td>
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<td></td>
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</tr>
<tr>
<td></td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Book gain</td>
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<td>1,500(2)</td>
</tr>
<tr>
<td></td>
<td>1,500</td>
<td>1,500(2)</td>
</tr>
<tr>
<td>Additional tax gain</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Capital after sale at end of Year 2</td>
<td>$10,500</td>
<td>$10,500</td>
</tr>
</tbody>
</table>

1 Book depreciation is calculated as 10 percent of $10,000 and tax depreciation as 10 percent of $6,000.

2 Book gain on sale is calculated as the sales price, $11,000, less the adjusted basis, $8,000 ($10,000 - (2 x $1,000)) or $3,000.

3 Tax gain on sale is calculated as the sales price $11,000, less the adjusted basis, $4,800 ($6,000 - (2 x $600)), or $6,200.

c. Points of worthwhile note: The above example illustrates a number of interesting points, including:

i. Disparity upon contribution: The built-in gain of the contributed property is reflected in the difference between the tax and book capital accounts of the contributor. The inherent appreciation is not, and cannot be, reflected in the contributor's tax basis for his partnership interest.

ii. Subsequent allocations: The section 704(b) regulations mandate that book/tax disparities be eliminated as quickly as possible. In theory, this would be accomplished by allocating all depreciation with respect to the contributed property to the noncontributing partner. However, this would violate the section 704(b) regulations. Regs. §1.704-1(b)(2)(iv)(g).

iii. Gain on sale: Any remaining inherent gain that has not been eliminated by partnership operations is first allocated the gain on sale. The remaining gain on sale, if any, may be allocated between the partners as they may agree, subject to the constraints imposed by section 704.
4. The ceiling rule: The current regulations limit the mandatory allocations of income, gain, loss and deduction with respect to contributed property, discussed above, to the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to it for Federal tax purposes. Regs. §1.704-1(c)(2)(i).

a. Effect: Application of the ceiling rule may limit the degree to which the mandatory allocations eliminate contributed property distortions.


H. Consequences of changes not resulting in termination of the partnership.

1. Partnership allocations.

a. Inclusion in income: The computation of a partner's taxable income requires the inclusion of that partner's share of partnership income, gain, loss, deduction or credit and guaranteed payments for the taxable year of the partnership that ends with or within the taxable year of the partner. I.R.C. §706(a).

b. Closing of taxable year: Certain events may cause the partnership's taxable year to close with respect to a partner before its normal year end closing. I.R.C. §706(c).

2. General rule: Unless the partnership terminates under section 708(b) and except to the extent provided in section 706(c)(2)(A) (dispositions of a partner's entire interest in the partnership), section 706(c)(1) provides that a partnership's taxable year does not close as a result of:

a. The death of a partner;

b. The entry of a new partner;

c. The liquidation of a partner's interest; or

d. The sale or exchange of a partner's interest in the partnership.
3. Closing of the taxable year for all partners: If the partnership terminates under section 708(b), the taxable year of the partnership closes with respect to all partners.

4. Closing of the partnership taxable year for a partner: The taxable year of the partnership closes for a partner who disposes of his entire partnership interest through a sale or exchange of the interest or by a liquidation of the interest by the partnership. I.R.C. §706(c)(2)(A); Regs. §1.706-1(c)(2)(i).

   a. Events: Sale or exchange transactions include both taxable and nontaxable events such as:

      i. Like kind exchanges under section 1031;

      ii. Contributions of partnership interests to controlled corporations (section 351) and pursuant to corporate reorganizations (section 368);

      iii. Arguably, contributions of partnership interests to other partnerships (but see Ltr. Rul. 8819083, which holds that the contribution of a partnership interest to another partnership is not a sale or exchange for purposes of section 708(b));

      iv. Distributions of partnership interests by corporations or partnerships; and

   b. Death of a partner: The death of a partner generally is not a disposition that closes the taxable year of the decedent partner prior to the end of the partnership's taxable year. I.R.C. §706(c)(2)(A)(ii).

      i. Buy/sell agreements: However, a buy/sell agreement between the partnership or the other partners and the decedent partner, effective at the date of decedent's death, will result in a closing of the tax year for the decedent's interest.

   c. Disposition of less than entire interest: The taxable year of a partnership does not close with respect to a partner who sells, exchanges, or reduces (by entry of a new partner, partial liquidation of a partner's interest or gift) less than his entire partnership interest. I.R.C. §706(c)(2)(B).
i. Terminations: However, the partnership taxable year could close for all of the partners as a result of a sale or exchange by one partner. For example, if A owns a 70 percent interest in the ABC Partnership and sells 80 percent of his interest (resulting in the sale of a 56 percent interest in the partnership), the partnership will terminate pursuant to section 708(b)(1)(B).

5. Consequences to the partner whose taxable year closes.

a. Partnership's year closes for partner: If the disposition of a partnership interest results in the closing of a partner's taxable year, the partner must include in taxable income, for his taxable year within or with which such membership in the partnership ends, the distributive share of income, gain, loss, deduction or credit, as well as any guaranteed payment. Regs. §1.706-1(c)(2)(ii).

b. "Bunching" of income may result: If the taxable year of the partnership is different from the taxable years of the partners, there may be a "bunching" of income. That is, the inclusion of more than 12 months of partnership income in the selling partner's taxable income in the year of sale. This possibility of the bunching of partnership income results in a number of planning opportunities or potential pitfalls for the selling partner, including:

i. Timing of the sale: If the sale occurs, for example, one day after the close of the partnership's year, no bunching will result.

ii. Staged Sale: A partner also may avoid a closing of the taxable year (and possible "bunching" of income) by selling 90 percent of the interest in one year and the remaining 10 percent in a future year. See, e.g., Ltr. Rul. 7902086.

iii. Tax rate changes: If the tax rate of the selling partner is expected to vary significantly from year to year, the sale can be structured to trigger any bunching in a low rate year. Thus, bunching is not always a negative, but may be used as a planning tool.
a. Example: Planning Partners has a June 30 taxable year (its natural business year) and reasonably expects to earn approximately $10,000 of taxable income each month for the next three years. Tired Partner has a 10 percent interest in partnership profits and losses and he will sell his interest to an unrelated third party, either in late 1989 or early 1990. Tired's marginal Federal tax rate in 1989 will be 28 percent. However, the tax reforms enacted as part of the anticipated Deficit Reduction Act of 1989 will boost his 1990 marginal rate to 50 percent. If he sells an December 31, 1989, Tired's share of partnership income will be $18,000 \((10 \text{ percent} \times \$120,000) + (10 \text{ percent} \times \$60,000)\), which will generate a Federal tax liability of $5,040 \((\$18,000 \times 28 \text{ percent})\). Should he sell on January 2, 1990, Tired will have a Federal tax liability from his share of partnership income of $6,360 \(((\$12,000 \times 28 \text{ percent in 1989}) + (\$6,000 \times 50 \text{ percent in 1990}))\). Thus, selling his interest three days earlier saves Tired $1,320 in Federal taxes, a savings of more than 26 percent.

b. Observations: The above example warrants a number of observations. Obviously, in addition to the bunching of income phenomenon, any gain on the sale of the interest must be considered, including the value of deferring the incidence of taxation. Secondly, state income tax considerations may reduce or magnify the savings illustrated above. Finally, the selling partner must have the cash with which to pay the tax. Cash flow and other business practicalities may outweigh the potential tax savings.

iv. Uneven income stream: If the partnership has an uneven stream of earnings (or large capital transactions) during the year, the partnership's method of closing its books may be of extreme importance. If the partnership use the pro rata method allowed by Regs. §1.706-1(c)(2)(ii), the proration may skew the amount of income allocated to
the selling partner, either to his benefit or detriment. (These allocation methods are discussed below.)

6. Computing the partner's distributive share.

a. Date of closing: If a partner's taxable year closes as a result of a disposition of a partnership interest, the first computation involves determining the date the partnership year closes. §706(c)(2)(A).

i. Sale of interest: If a partner sells or exchanges his entire interest, the date the partnership year closes for the selling partner occurs when the benefits and burdens of ownership actually shift.

ii. Liquidation of interest: If a partner's interest is liquidated, the partnership year closes on the date that the partner receives the final payment in liquidation of the interest. Until then, the partnership interest is treated only as being reduced. Regs. §1.761-1(d).

b. Allocation of income: The second computation involves the allocation of partnership income (or loss) with respect to the partner's interest. I.R.C. §706(d).

i. Varying interests rule: Where there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction or credit is allocated to each partner in a manner which takes into account the varying interests of the partners in the partnership during the taxable year. I.R.C. §706(d)(1). See, Rev. Rul. 77-310, 1977-2 C.B. 217.

ii. Methodology: Allowable methods to determine a partner's varying interest include:

a. Interim method: Where less than an entire partnership interest is sold, exchanged, or liquidated (including the entry of a new partner), the partnership may close the books on an interim basis in order to determine the share of income, gain, loss deduction, and credit to be allocated to the outgoing partner. Regs.
§1.706-1(c)(2)(ii). An interim closing of the partnership books:

i. Can be expensive and is not feasible in publicly traded partnerships.

ii. Allows the partnership to use a semi-monthly convention. Partners entering in the first 15 days of the month are considered as entering at the beginning of the month. Partners entering after the 15th day of the month are treated as entering at the beginning of the next month. IR-84-129 (December 13, 1984).

b. Monthly pro rata method: To avoid an interim closing, the partners may agree to estimate the outgoing partner's share of income by prorating the entire year's income. Reg. §1.706-1(c)(2)(ii). The outgoing partner's pro rata share of income can be determined by either:

i. The number of days he was a partner of the partnership; or

ii. Any other reasonable method. Regs. §1.706-1(c)(2)(ii). A partnership that uses the proration method is not permitted to use a semi-monthly convention. IR-84-129 (December 13, 1984).

c. Any other reasonable method: The partners may also use any other reasonable method (e.g., a hybrid of the interim closing and monthly pro rata methods) for allocating items among the partners.

d. Special rule for cash method partnerships: A special rule applies for the allocation of certain items by a cash method partnership. Specifically, this rule was enacted to prevent a cash method partnership from delaying payment of certain "accrued" expenses in order to shift the allocation of such items to incoming partners. I.R.C. §706(d)(2).
i. The particular "allocable cash basis items" are: Interest expense, taxes, payments for services or for the use of property, and any other item that may result in a significant misstatement of income. I.R.C. §706(d)(2)(B).

ii. Income items, along with items of deduction, are also subject to this special rule.

iii. These cash basis items must be allocated on an economic "accrual" basis to the day on which the item was incurred and must be allocated only to partners that were in fact partners of the partnership on the close of the day the item was incurred. I.R.C. §706(d)(2)(A).

iv. If the item is deductible in a year other than in the year in which it is incurred, any amounts that would be allocated to partners who are no longer partners of the partnership at the time of payment must be capitalized and allocated to other assets. I.R.C. §706(d)(2)(D).

IV. **Basis of a Partner's Interest in the Partnership.**

A. **Theory of a partner's basis.**

1. **Nature of a partnership interest:** A partner's interest in a partnership is similar to a shareholder's stock ownership in a corporation. The partnership interest gives the partner a proprietary claim against the assets of the partnership.

2. **Purpose:** The purposes for determining a partner's basis in a partnership essentially are threefold:

   a. **Measure gain or loss on sale:** A partner's basis is used to measure the gain or loss from a sale or taxable exchange of a partner's interest in the partnership or the liquidation of a partner's interest in the partnership (I.R.C. §§741 and 736);
b. Determine basis of property received in liquidation: A partner's basis is used in determining the basis of partnership property (other than money) received in liquidation of the partner's interest in the partnership (I.R.C. §732(b)); and

c. Set limit on deductibility of losses: A partner's basis is important because it is used to limit the deductibility of a partner's share of partnership losses. I.R.C. §704(d).

3. "Outside" versus "inside" basis: Many times, a partner's basis for his partnership interest (the "outside" basis) does not equal his share of the partnership's basis for its assets (the "inside" basis).

a. Reasons for the discrepancy: This inequality may occur, for example, as a result of the acquisition of a partnership interest through purchase (or inheritance).

b. Purchase of partnership interest: If a partnership interest is acquired from an existing partner, the purchasing partner will take a cost basis in the partnership interest, which may be higher or lower than the basis of the partnership interest in the hands of the selling partner.

i. Result: As a result, the purchasing partner's basis in the partnership interest will differ from his share of the basis of the partnership's assets.

ii. Section 754 election as a remedy: To equalize the inside and outside bases, the partnership may elect to adjust the basis of its assets. I.R.C. §743(b). (However, in many circumstances, the basis allocation required by a section 754 election will not mirror the value of the partner's undivided interest in partnership property. Regs. §1.755-1(a).)

4. Capital account not determinative: A partner's basis in his partnership interest is determined independently of the partner's capital account. Regs. §1.705-1(a)(1).

a. Capital accounts maintained under section 704(b): However, capital accounts must be properly maintained to demonstrate the "economic effect" of an allocation of income (or loss). I.R.C. §704(b).
b. At risk amounts separately computed: Additionally, for purposes of determining the limitation of loss deductions, partners must separately compute their amounts at risk in partnership activities. I.R.C. §465.

B. General rule for basis determination.

1. Basis upon acquisition: A partner's initial basis for his partnership interest is determined in one of two ways.

a. Substituted basis: If the partnership interest is acquired as a result of a contribution of money or other property, the contributing partner's basis equals the amount of money contributed plus the adjusted basis to the contributor of any property contributed. I.R.C. §722.

b. Cost basis: If a partnership interest is acquired other than as a result of a contribution of property (e.g., by purchase of an existing partner's interest or acquisition of a partnership interest from a decedent), the partner's basis is determined under the general basis rules of sections 1011, 1012, 1014, etc. I.R.C. §742.

2. Adjustments to basis — Partnership operations: As a result of the operations of the partnership, the basis of a partner's interest in the partnership will either increase or decrease. I.R.C. §705.

a. Increases to basis: The basis of a partnership interest is increased by:

i. Contributions: Additional contributions to the partnership or other forms of acquisition (e.g., purchases) (I.R.C. §§722 and 742);

ii. Distributive share of income items: The partner's share of partnership taxable income, tax-exempt income, and depletion deductions in excess of the basis of the property subject to depletion (I.R.C. §705(a)(1)); and

iii. Increases in liabilities: An increase in the partner's share of partnership liabilities (including partnership liabilities assumed by the partner). I.R.C. §752(a).
b. Decreases to basis: A partner's basis is decreased by:

i. Distributions: Distributions of money or other property from the partnership (I.R.C. §733);

ii. Distributive share of losses: The partner's share of partnership losses and non-deductible, non-capitalized expenditures (I.R.C. §705(a)(2));

iii. Decreases in liabilities: Any reduction in a partner's allocable share of partnership liabilities (I.R.C. §752(b));

iv. Depletion deductions: The partner's deduction for depletion with respect to certain oil and gas property of the partnership (but not in excess of the partner's proportionate share of adjusted basis of such property) (I.R.C. §705(a)(3)); and

v. ITC property basis adjustments. (I.R.C. §48(q)).

3. Additional considerations.

a. No negative basis: The basis of a partner's interest in a partnership cannot be reduced below zero. I.R.C. §705(a)(2) and (a)(3). Instead of reducing basis below zero, a partner is fully taxed on distributions of cash (including constructive liability relief) in excess of basis, and then takes a zero basis in any non-cash property distributions. I.R.C. §§731 and 732.

b. Ordering and timing of basis adjustments.

i. Purpose: The ordering rules are designed to prevent a partner from deducting partnership losses prior to reducing that partner's basis by distributions.

a. Losses considered last: In determining a partner's basis for purposes of the limitation of section 704(d), a partner's basis is first increased for his distributive share of partnership income items under section 705(a)(1), and decreased by distributions and other items under section 705(a)(2) except for losses.
The partner's basis thus determined serves as the limitation on the
deduction of partnership losses.
Regs. §1.704-1(d)(2).

C.B. 166, illustrates the ordering
rules for determining a partner's
basis for partnership loss purposes.
Distributions from the partnership
(including cash distributions) reduce
a partner's basis before partnership
losses are allocated. Rev. Rul.
66-94, supra.

c. Losses suspended on pro rata basis:
If losses exceed the partner's basis,
the deductible losses are deemed to
consist of a pro rata share of each
type of loss (e.g., ordinary and
capital loss). Regs. §1.704-1(a)(2).
(A different ordering rule exists for
losses suspended under the at risk
rules. Prop. Regs. §1.465-38. This
dichotomy may be corrected in an
amendment to the at risk regulations.)

ii. Determination date.

a. General rule: Normally, in computing
the partner's basis for purposes of
calculating gain on a cash
distribution the partner's basis must
be determined through the date of the
distribution.

b. Exception: Advances or drawings
against a partner's distributive share
of partnership income are treated as
made on the last day of the year.
Regs. §1.731-1(a)(1)(ii).

c. Practical point: Distributions other
than a draw may trigger a gain under
section 731(a), even if the recipient
partner anticipates sufficient
partnership income by year end to
cover the draw. For example, A and B
form a partnership, AB, to provide
services. AB adopts the cash method
of accounting and does not include a
draw provision in its partnership
agreement. A and B agree to share
income equally and they each make a
$10,000 capital contribution to the
partnership. On March 31, the partnership distributes $25,000 to A. Partnership income of $120,000 is earned ratably during the year. The partnership has no liabilities. If the March distribution is not considered an advance against current year earnings, A will recognize a gain under section 731(a) of $15,000, in addition to his distributive share of partnership income of $60,000. A's basis at March 31 is $10,000 because he is not credited for any portion of current year earnings until the end of the year. Regs §1.705-1(a)(1). Therefore, his gain is equal to $15,000. As a practical matter, many partnerships (especially professional service firms) should consider incorporating a draw provision into their partnership agreement.

c. Charitable contributions: A partner's share of partnership charitable contributions is not subject to the basis limitation. See, Regs. §1.704-1(d)(2) where charitable contributions separately stated under section 702(a)(4) are omitted from the partner's basis computation. See also, Ltr. Rul. 8753015.

d. Dual interests: A partner holding both a general and limited interest in the same partnership is treated as having a single (combined) basis for both interests. Rev. Rul. 84-53, 1984-1 C.B. 159. (A similar rule applies to combine a partner's multiple interests for capital accounting purposes. Regs. §1.704-1(b)(2)(iv)(b).)

C. Partnership liabilities.

1. General rule: As discussed previously, partnership liabilities affect the bases of the individual partners. This ability of a partner to include entity level liabilities in basis is a primary distinction between partnerships and S corporations.

a. Increases to basis: A partner's basis in his partnership interest is increased by:

i. Any increase in the partner's share of partnership liabilities; or
ii. Any increase in a partner's personal liabilities by reason of the assumption of partnership liabilities. I.R.C. §752(a).

b. Decreases to basis: A partner's basis in his partnership interest is decreased by:

i. Any decrease in the partner's share of partnership liabilities; or

ii. Any decrease in the partner's personal liabilities by reason of their assumption by the partnership. I.R.C. §752(b).

c. Nonrecourse debt: The basis attributable to nonrecourse indebtedness encumbering contributed or distributed property is limited to the fair market value of the encumbered property. I.R.C. §752(c).

i. Commissioner v. Tufts: Section 752(c) applies only to transactions between partners and the partnership under sections 752(a) and (b) and not to sales of partnership interests. Commissioner v. Tufts, 461 U.S. 300 (1983) ("Tufts"). In Tufts, supra, the taxpayers sold their interests in a partnership to an unrelated third party, who assumed the partnership's nonrecourse mortgage which was in excess of the partnership's property's fair market value. The taxpayers argued that section 752(c) limited their amount realized on the sale to the fair market value of the property sold. The Supreme Court, however, held that section 752(c) did not apply to the sale of partnership interests and was restricted to section 752(a) and (b) transactions.

d. Sale of an interest: If a partnership interest is sold, the selling partner is required to include his share of partnership liabilities in the amount realized. A partner's share of partnership liabilities is similarly included in that partner's basis. I.R.C. §752(d).

2. A partner's share of partnership liabilities.

a. General rule: The regulations under section 752 set forth the rules, as prescribed by the Treasury, for allocating partnership liabilities among the partners. As noted below, the
Treasury has been instructed by Congress to revise these regulations.

b. Two factors considered: The current regulations differentiate a partner's share of partnership liabilities, depending upon two factors: (1) The type of liability involved (i.e., recourse or nonrecourse); and (2) The character of the interest held by the partner (i.e., general or limited).

i. Recourse liabilities.

a. Loss ratios: Recourse liabilities are allocated according to the partners' respective loss sharing ratios.

b. Limited partners. A limited partner's share of partnership recourse liabilities is limited to the lesser of:

i. The total capital contributions that the limited partner is obligated to make under the partnership agreement in excess of actual contributions; or

ii. The partner's share of such liabilities based upon his (or her) loss sharing ratio. Regs. §1.752-1(e).

ii. Nonrecourse liabilities: All partners (both general and limited) share the basis attributable to nonrecourse liabilities according to their profit sharing ratios. Regs. §1.752-1(e).

a. Definition: Nonrecourse liabilities are defined as partnership debts for which none of the partners has any personal liability.

b. Example: A nonrecourse debt includes a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage.
3. Interpretations of section 752.

a. Liabilities of cash method partnerships, etc.

i. Accounts payable: Accrued but unpaid expenses and accounts payable are not "partnership liabilities" for purposes of computing the adjusted basis of a partner's interest in a cash basis partnership. Rev. Rul. 88-77, 1988-38 I.R.B. 8.

ii. Contributions of accrued liabilities: The 1984 General Explanation indicates that contributions of accrued but unpaid liabilities (e.g., accounts payable) by a cash method partner to a partnership will be treated similarly to section 357(c) items in a corporate tax context. Thus, those items should **not** be treated as liabilities for purposes of section 752. 1984 General Explanation, supra, at 215.


b. Contributions to capital versus loans.

i. Loans to partners: A partner's receipt of money from a partnership under an obligation by the partner to repay the funds constitutes a loan, and thus a liability of the partnership, rather than a distribution. To the extent such obligation is cancelled, the obligor partner will be considered as having received a distribution at the time of the cancellation. Regs. §1.731-1(c).

ii. Loans by the general partner: Nonrecourse loans by the general partner to either the limited partners or the partnership may constitute capital contributions to the partnership by the general partner, rather than loans. Rev. Rul. 72-135, 1972-1 C.B. 200.
iii. Convertible debt: A nonrecourse loan by an unrelated third party to a partnership, secured by the partnership's property and convertible at the option of the lender into an interest in the partnership's profits may be treated as a capital contribution rather than as a loan. Rev. Rul. 72-350, 1972-2 C.B. 394.

iv. Advances to the partnership by the partners considered equity: Advances to a partnership by a partner have been held to be capital contributions (rather than loans) where the loans were noninterest-bearing, unsecured, subordinated debt. Hambuechen v. Commissioner, 43 T.C. 90 (1964).

v. Advances to the partnership by the partners considered loans: Advances to a partnership by a partner were held to be loans (rather than capital contributions) where repayments were made regularly, notes were given, the advances were not subordinated, and the partnership's capitalization was not abnormal. Kingbay v. Commissioner, 46 T.C. 147 (1966).

c. Tiered partnerships: A limited partner's basis for his interest in a first tier limited partnership includes that partner's share of the second tier partnership's nonrecourse liabilities which are allocated to the first tier partnership. Rev. Rul. 77-309, 1977-2 C.B. 216.

d. Partner guarantees, indemnifications, and assumptions of nonrecourse debt of the partnership.

i. Definition: As noted above, a nonrecourse debt is defined as a debt for which none of the partners has any personal liability. If the liability qualifies as nonrecourse under this definition, it is shared in accordance with the partners' profit sharing ratios. Regs. §1.752-1(e).

ii. Guarantees by general partner: The Service has ruled that where a general partner personally guarantees partnership nonrecourse debt, the debt is treated as recourse, thus preventing a basis increase to the limited partners. Rev. Rul. 83-151, 1983-2 C.B. 105.

b. Partial guarantees: The Service holds that a guarantee of only a portion of a nonrecourse debt permits the nonguaranteed portion to retain its status as a separate nonrecourse liability, thereby allowing a basis increase to the nonguarantor partners. Rev. Rul. 84-118, 1984-2 C.B. 120.

c. Congressional mandate: As part of the 1984 Act, Congress directed the Treasury to revise the section 752 regulations to specify that a general partner's primary or secondary liability on partnership indebtedness precludes its classification as nonrecourse debt for purposes of determining limited partners' bases. 1984 General Explanation, at 251.

iii. "Ultimate liability" standard: Recently, the Tax Court has applied an "ultimate liability" test in allocating nonrecourse indebtedness for basis purposes where the liabilities have been guaranteed by partners.

a. Assumption agreement by general partner: The court applied the "ultimate liability" test to determine whether a general partner in a partnership was entitled to include in basis the entire amount of a "nonrecourse" partnership debt for which he assumed personal liability through the execution of an "assumption agreement" with the partnership. The court held that, despite the fact that the partnership's assets were subject to the debt, the partnership could look to the partner for indemnification, and thus the partner was "ultimately liable" to pay the debt. The partner therefore, was entitled to include the

b. Guarantees by limited partners: In Abramson v. Commissioner, 86 T.C. 360 (1986) ("Abramson"), the court permitted limited partners to increase their bases as a result of guaranteeing a "nonrecourse" debt. The limited partners were "ultimately liable" for the portion of the debt that they guaranteed because the general partners were not primarily or secondarily liable.

c. Ultimate liability doctrine circumscribed: A limited partner was not at risk for his guarantee of a portion of partnership nonrecourse indebtedness in an equipment leasing transaction. The taxpayer limited partner guaranteed a portion of the partnership's nonrecourse debt in an amount approximating his expected share of partnership losses, less his capital contribution. The guarantee was not required by the lender and the taxpayer had a right under state law of subrogation against the partnership. The partnership, in turn, had a guarantee from the parent of the lessee for the lease payments on the partnership's equipment. Therefore, the taxpayer was not the primary obligor on the partnership debt and did not have ultimate liability for the debt. Peters v. Commissioner, 89 T.C. 423 (1987) ("Peters"). (The decision in Peters marks the court's first attempt to reign in the broad reach some tax practitioners had given to guarantees and the "ultimate liability" doctrine espoused in Abramson, supra.)

e. Partner guarantees, indemnifications, and assumptions of recourse debt of the partnership.

i. Current regulations: The current section 752 regulations deny a limited partner basis for recourse obligations of a partnership, except to the extent of the difference between the contribution credited to the limited partner by the partnership and the total contribution
which the limited partner is obligated to make. Regs. §1.752-1(e).

a. "Outside" indemnifications: The Service has interpreted the regulations to provide that a limited partner's agreement (outside of the partnership agreement) to indemnify a general partner with respect to the general partner's share of partnership recourse liabilities does not entitle the limited partner to a basis increase. Rev. Rul. 69-223, 1969-1 C.B. 184.

b. "Outside" guarantees: Similarly, the mere guarantee by a limited partner of partnership recourse debt did not allow the limited partner to include a portion of the recourse debt in basis, where the guarantee was outside the partnership agreement. See, e.g., Block v. Commissioner, 41 TCM 546 (1980); and Brown v. Commissioner, 40 T.C.M. 725 (1980), aff'd, 698 F.2d 1228 (9th Cir. 1982).

ii. "Ultimate liability" standard: Recently, the Tax Court and the Internal Revenue Service have interpreted the regulations as allowing a limited partner to increase the basis in his partnership interest to the extent the partner is "ultimately liable" for a pro rata portion of the recourse debt of the partnership.

a. Limited partner guarantee with no right of indemnification: In Gefen v. Commissioner, 87 T.C. 1471 (1986) ("Gefen"), the court held that a limited partner was entitled to include in basis her allocable share of partnership recourse liabilities which she had guaranteed. The court focused on the fact that the limited partner was not a mere guarantor of her pro rata share of the partnership debt, but was ultimately liable since she was required under the partnership agreement to make additional capital contributions in the event the partnership was called upon to satisfy the debt. Furthermore, she had no right of indemnification from the general partner (or anyone else) if
she was called upon to make the additional capital contributions or to satisfy the guarantee.

b. Limited partner's recourse note pledged as collateral for partnership's recourse loan: The Tax Court has applied the "ultimate liability" analysis set forth in Gefen, supra, to allow a limited partner to increase his amount at risk by the amount of recourse liabilities for which he was ultimately liable. "The critical inquiry should be who is the obligor of last resort, and in determining who has the ultimate economic responsibility for the loan, the substance of the transaction controls." In Melvin v. Commissioner, 88 T.C. 63 (1987) ("Melvin"), the taxpayer incurred an obligation to contribute additional capital which was represented by a recourse note he had contributed to the partnership. The note, in return, was pledged as collateral for a recourse loan taken out by the partnership. The court found that the limited partner had no right of reimbursement for any amount which he was required to contribute to the partnership as evidenced by the note. Accordingly, he could include as an amount at risk and in basis his pro rata share of the recourse debt.

c. Limited partners assume liability for proportionate share of partnership recourse debt: In a Technical Advice Memorandum, the Service found that a limited partner was entitled to include in basis his pro rata share of a recourse debt of the partnership. Under the partnership agreement, each limited partner agreed to assume liability for a proportionate share of certain recourse debt of the partnership. The Service, after examining the partnership agreement, noted that the assumption of partnership indebtedness was to be treated as a capital contribution. Citing Abramson, supra, the Service accepted the concept of ultimate liability and concluded that the limited partner incurred direct and
ultimate liability for his pro rata share of the recourse liability. The Service found that the partner's assumption of the debt was made as part of his agreed upon contribution to the partnership. Tech. Advice Memo. 8702006. See also Tech. Advice Memo. 8749009 where the limited partners' shares of the partnership's recourse bank loan were evidenced by recourse notes contributed to the partnership (and assigned to the bank as security for the line of credit) and assumption agreements between the partners and the bank.

4. Revision of the section 752 regulations.

a. Congressional mandate: As part of the 1984 Act, Congress directed the Treasury to revise the section 752 regulations to ensure that the partner receiving a basis increase attributable to a partnership liability bears the economic risk of loss with respect to such liability. 1984 General Explanation, at 250-251.

i. Claims Court decision in Raphan overturned by Congress: Congress legislatively overturned the decision in Raphan, supra, which held that a general partner was not to be treated as personally liable with respect to an otherwise nonrecourse debt because he guaranteed repayment of the debt. The court held that the debt was a nonrecourse liability and the limited partners were entitled to increase their respective bases by their proportionate share of the liability.

ii. Raphan reversed by Federal Circuit: As indicated above, the decision reached by the Claims Court in Raphan, supra, holding that the general partner had no personal liability with respect to the guarantee of a nonrecourse debt, was subsequently reversed. Raphan v. United States, 759 F.2d 879 (Fed. Cir. 1985).

b. Guarantees: As currently written, the regulations do not directly address the consequences of a partner (either general or limited) guarantee of a nonrecourse partnership liability. Regs. §1.752-1(e).
i. General partner: The revised regulations presumably should (but do not yet) provide that if a general partner is either primarily or secondarily liable (as in the case of a guarantee) for a nonrecourse debt of the partnership, the debt will be treated as a recourse debt of the partnership to the extent of the guarantee.

a. Ramifications: As a result, a limited partner's share of the liability will be subject to the rules set forth in the current regulations for sharing recourse debt. Unless the limited partner is required to make additional capital contributions which could be used to satisfy the guaranteed debt (or is otherwise ultimately liable for the debt), he will not be entitled to share in the liability for basis purposes.

ii. Limited partner: Where a limited partner guarantees a nonrecourse liability, the revised regulations should (but do not yet) provide that the limited partner will be entitled to a basis increase equal to the liability guaranteed.

a. Current regulations: Under the current regulations, a guarantee by any partner converts the liability to a recourse debt. Since limited partners typically do not share in partnership recourse liabilities, the limited partner would not be entitled to a basis increase despite the partner's potential economic loss as a result of guaranteeing the liability.

b. Revised regulations: It is anticipated, however, that the revised regulations will adopt the "ultimate liability" theory as expressed in Abramson, Gefen, and Melvin, supra. Accordingly, to the extent the limited partners are ultimately liable they should receive a corresponding increase in basis.

iii. Nonrecourse loans by a partner to a partnership: The regulations, once revised, should provide that the basis attributable to a nonrecourse loan made to the partnership by a partner is treated in
the same manner as if that partner guaranteed a third party nonrecourse debt of the partnership. As previously discussed, the guarantee of a nonrecourse partnership debt by a partner should generally entitle the guarantor partner to a basis adjustment equal to the amount of the guarantee.

iv. Other commercial practices: The new regulations should also take into account current commercial practices and arrangements relating to partnership liabilities, including assumptions, indemnity agreements and other similar agreements. The partner(s) ultimately liable for such indebtedness should be entitled to include the debt in basis.

v. Effective dates: The revised regulations, to the extent they overrule the Raphan decision, are to be effective retroactively from March 1, 1984.

a. However, to the extent the regulations apply to transactions other than that in Raphan, supra, the regulations are to apply prospectively.

b. It is uncertain whether the regulations will apply prospectively to debts incurred after their effective date or taxable years beginning after their effective date.

D. Limitations on deductibility of partnership losses by partners.

1. Section 704(d): The basis limitation.

a. Loss limitation: A partner's distributive share of partnership loss shall be allowed as a deduction only to the extent of the adjusted basis of the partner's interest at the end of the partnership year in which the loss occurs. I.R.C. §704(d).

b. Carryforward of suspended losses: Any disallowed loss carries forward, and will be allowed as a deduction in a following year to the extent such partner's basis shows a net increase after considering all other items affecting basis for that year.
i. Methods to increase basis: For those partners who may be subject to a possible basis limitation, there are a number of ways in which a partner may increase his (or her) basis. Methods to accomplish an increase in basis include:

a. Additional cash contributions by a partner.

b. Increases in a partner's share of partnership liabilities.

c. Contributions of property by a partner.

d. Assumption by a partner of partnership debt.

e. Partnership earnings.

ii. Timing: The partner's basis must increase prior to the date the person ceases to be a partner in the partnership.

a. One taxpayer has argued that a contribution of capital to a partnership after a sale of his partnership interest should allow the partner to deduct any suspended losses. The Tax Court has denied a deduction for the suspended losses. Sennett v. Commissioner, 80 T.C. 825 (1983).

b. Planning: Once again, timing is important. Partners should make planned capital contributions to a partnership prior to selling their partnership interests in order to be able to deduct any suspended losses.

c. Scope: Unlike the "at risk" rules, the basis limitation applies to all taxpayers, not just to individuals and certain corporations.

V. The Partners' Dealings With the Partnership.

A. Payments by a partnership to a partner.

1. Categories of payments.

a. General rule: A partner may engage in business transactions with a partnership in which he is a member. For example, the partner may perform
services for the partnership, the partner and the partnership may engage in lending transactions, or the parties may enter into leasing agreements. The applicable tax treatment depends upon the type and substance of the transaction involved.

b. Categories: The Code categorizes three classes of transactions between a partner and the partnership and subjects each to a different set of rules. The three classes of transactions are:

i. Payments to a partner not acting in his capacity as a partner (I.R.C. §707(a));

ii. Guaranteed payments to a partner, acting in his capacity as a partner, for services or the use of capital to the extent determined without regard to the income of the partnership (I.R.C. 707(c)); and

iii. All other payments to a partner acting in his capacity as a partner. I.R.C. §§702 and 704.

c. Tax treatment: The tax treatment of the transaction depends upon whether the governing provision is section 707(a), section 707(c), or section 704. Generally, if section 707(a) applies to a transaction, the partner is treated for tax purposes as an unrelated party and the transaction is governed by the Code provisions governing income inclusions and expense deductions. A guaranteed payment (under section 707(c)), on the other hand, always results in the recognition of ordinary income by the recipient and a deductible or capitalizable expenditure for the partnership. Finally, if the transaction falls within the provisions of sections 702 and 704, the payment is treated as a distribution of the partner's distributive share of the partnership income.

i. Timing of income and deduction.

a. Section 704: A partner recognizes his distributive share of partnership income (or loss) in the partner's taxable year which contains or ends with the partnership's taxable year end, regardless of whether any distributions are received. I.R.C. §706; Regs. §1.706-1(a)(1).
b. Section 707(a): A recipient recognizes income from a section 707(a) payment according to his method of accounting (e.g., in the year in which it is received if the partner is on the cash method or in the year earned if on the accrual method.) The partnership deducts (if the item is deductible) or capitalizes the item according to its general method of accounting. However, if the partner is a cash method taxpayer and the partnership uses the accrual method, the partnership is only entitled to a deduction in the year in which the recipient includes the payment in income. I.R.C. §267(a)(2).

c. Section 707(c): The recipient must include the guaranteed payment in income in his taxable year which contains or ends with the end of the partnership taxable year in which the partnership deducts such payments as paid or accrued under its method of accounting. Regs. §1.707-1(c). Significantly, this may result in cash free taxable income to a cash basis partner if the accrual basis partnership accrues a guaranteed payments.

2. Characterization of certain payments: The proper characterization of payments between partnerships and partners has frequently been the subject of litigation.

a. Payments as a percentage of gross income: The Tax Court has held that payments to a partner based on a percentage of partnership gross income are not guaranteed payments. However, since the payments were made to a partner for services performed in his capacity as a partner (per the partnership agreement), the payments were not section 707(a) payments. Rather, they represented a portion of the partner's distributive share of partnership income under section 704. Pratt v. Commissioner, 64 T.C. 203 (1975), aff'd, 550 F.2d 1023 (5th Cir. 1977) ("Pratt").

i. IRS position: The Service has taken a view contrary to that in Pratt, supra, and has held that the payments were guaranteed payments under section 707(c). The Service
indicated that the term "guaranteed payment" should not be limited to fixed amounts. Rather, in the Service's view, a payment for services determined by reference to an item of gross income is a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits. Rev. Rul. 81-300, 1981-2 C.B. 143. (However, see, Tech. Advice Memo. 8642003 comparing Pratt, supra, and distinguishing Rev. Rul. 81-300, supra.)

ii. Congressional response: As part of the 1984 Act, Congress addressed the problem of the proper characterization of certain payments between partners and the partnership. In choosing a middle ground, Congress agreed with the Service that the payments should not represent a portion of the partner's distributive share, but disagreed that the distribution represented a guaranteed payment under section 707(c). Rather, the transaction should be treated as a payment to a partner not acting in his capacity as a partner under section 707(a). Senate Committee Report, Tax Reform Act of 1984, S. Rep. No. 169, 98th Cong., 2d Sess. (the "Senate Report") at 224-225.

b. Section 707 payments as disguised fees: In a fairly recent decision, the Tax Court found that organization and syndication costs, labeled as management fees, paid to the general partner by a limited partnership were paid while the general partner was acting in his capacity as a partner and therefore, did not qualify as section 707(a) payments. Because the payments were for organization and syndication costs, the court held that section 707(a) applied. Section 709(a) precludes a partnership from currently deducting partnership organization and syndication expenses whether paid directly or indirectly through payments to a partner. Egolf v. Commissioner, 87 T.C. 34 (1986).

3. Disguised payments for services or property.

a. Background: Among other things, Congress felt that partnerships had been used effectively to circumvent the requirement to capitalize certain expenses by making allocations of income and corresponding distributions in place of direct
payments for property or services. As a result, Congress mandated that certain income allocations (and subsequent related distributions) be capitalized. Senate Report, at 225.

i. Creating "deductible" section 709 fees: The Senate Report expressed concern that an allocation and distribution of gross or net income to an organizer or syndicator who is a general partner may have the effect of allowing a partnership to deduct amounts which are properly nondeductible organization and syndication costs.

b. General rule: As a result of this Congressional concern, the Code now provides that if a partner performs services for a partnership or transfers property to a partnership and there is a related allocation or distribution to that partner, the allocation will be ignored if the facts and circumstances indicate that the recipient was not acting in his capacity as a partner. I.R.C. §707(a)(2)(A).

   i. Reach of the rule: Under appropriate circumstances, the purported partner performing the services or transferring the property may not be deemed to be a partner at all for tax purposes.

   ii. Example: The Senate Report provides an example of when an allocation of partnership gross income should be treated as a section 707(a) payment. A commercial office building constructed by a partnership is projected to generate gross income of at least $100,000 per year indefinitely. Its architect, whose normal fee for such services is $40,000, contributes cash for a 25 percent interest in the partnership and receives both a 25 percent distributive share of net income for the life of the partnership and an allocation of $20,000 of partnership gross income for the first two years of partnership operations after lease-up. The partnership is expected to have sufficient cash available to distribute $20,000 to the architect in each of the first two years, and the agreement requires such a distribution.
iii. Character: The purported gross income allocation and partnership distribution in the above example should be treated as a fee under section 707(a), rather than as a distributive share because as to those payments the architect is presumably insulated from the risk of the joint enterprise.

iv. Factors: Factors which contribute to this conclusion are:

a. The special allocation to the architect is fixed in amount and there is a substantial probability that the partnership will have sufficient gross income and cash to satisfy the allocation/distribution;

b. The distribution relating to the allocation is fairly close in time to the rendering of the services; and

c. It is not unreasonable to conclude from all the facts and circumstances that the architect became a partner primarily for tax reasons.

v. Alternative: On the other hand, if the agreement allocates to the architect 20 percent of gross income for the first two years following construction of the building, a question arises as to how likely it is that the architect will receive substantially more or less than his imputed fee of $40,000. If the building is pre-leased to a creditworthy tenant under a lease requiring the lessee to pay $100,000 per year of rent, or if there is a low vacancy rate in the area for comparable space, it is likely that the architect will receive approximately $20,000 per year for the first two years of operations. Therefore, the architect assumes limited risk as to the amount or payment of the allocation and, as a consequence, the allocation/distribution should be treated as a disguised fee. If, on the other hand, the project is a "spec building," and the architect assumes significant entrepreneurial risk that the partnership will be unable to lease the building, the special allocation (even though a gross income allocation), depending on all the facts and circumstances, might be properly
treated as a distributive share and a genuine partnership distribution. Senate Report, at 229-230.

c. Six factors: If the service performer or property transferor is actually a partner for tax purposes, the legislative history provides six factors that should be considered in determining whether the allocations and distributions are made to the partner in his (or her) capacity as a partner:

i. Risk: Whether the payment is subject to an appreciable risk as to the amount and fact of the payment based upon the success or failure of the joint undertaking.

ii. Transitory status: Whether the status of a partner is transitory.

iii. Timing: Whether the distribution and allocation made to the partner are close in time to the performance of services for or to the transfer of property to the partnership.

iv. Tax motivation: Whether it appears that the recipient became a partner primarily to obtain tax benefits individually or for the partnership as a joint undertaking.

v. Relative value: Whether, in the service context, the value of the recipient's interest in general and continuing partnerships profits is small in relation to the allocation in question.

vi. Whether in the property context, the substantial economic effect requirement of section 704(b) makes income allocations, which are disguised payments of capital, unlikely to occur. Senate Report, at 227-228.

4. Disguised sales: The Senate Report also addresses the issue of disguised sales. Specifically, when a partner transfers money or property to a partnership and there is a "related" transfer of money or property by the partnership to the partner, the transaction will be treated as a sale between the partners or as a partial sale and contribution of the property to the partnership. I.R.C. §707(a)(2)(B).
a. Reason for the rule: This provision is designed to prevent the parties from characterizing a sale or exchange of property as a contribution to the partnership followed by a tax-free distribution from the partnership. See, e.g., Otey v. Commissioner, 70 T.C. 312 (1978), aff'd per curiam, 634 F.2d 1046 (6th Cir. 1980); Park Realty Co. v. Commissioner, 77 T.C. 412 (1981).

b. Reach of the rule: Because of the potentially broad reach of the statutory language, prudent tax planners should carefully consider section 707(a)(2)(B) in structuring transactions in which there is even the appearance of a "related" transfer. For a further discussion of the provision, see Bobrow and Friedman, "Section 707(a)(2)(B): Some Considerations in the Anti-Otey Provisions, 3 J. Partnership Tax. 346 (Winter 1987).

5. Guaranteed payments.

a. General rule: An amount is a guaranteed payment if it is payable in all events, regardless of whether it exceeds the partnership's net income.

b. Services or capital: Guaranteed payments must be for services (e.g., salary payments) or for the use of capital (e.g., interest on partners' capital) and must be made to a partner acting in his capacity as a partner.

c. Compare with other types of payments: A guaranteed payment should be distinguished, under a facts and circumstances test, from other types of payments such as:

i. Loans: A loan in which a partner has an obligation to repay the partnership; and

ii. Profits: Distribution of a partner's profit share, which is charged against the partner's capital account.

d. Inclusion in income.

i. General rule: Guaranteed payments are included in the recipient's gross income as ordinary income. Regs. §1.707-1(c).

a. The general rule applies even though a partnership has no taxable income or its income consists entirely of capital gains.
b. Furthermore, the general rule applies even if a partnership is required to capitalize the payment. Rev. Rul. 80-234, 1980-2 C.B. 203.

ii. Timing of the inclusion in income: Section 707(c) requires a matching of the income and deduction. The recipient must include the guaranteed payment in "his taxable year within or with which ends the partnership taxable year in which the partnership deducts such payments as paid or accrued under its method of accounting." Regs. §1.707-1(c). For the recipient partner, this may result in the recognition of income even though an actual distribution has not been made by the partnership. (In short, cash free taxable income.)

e. Deductibility by the partnership: Guaranteed payments are generally deductible by the partnership. In some cases, however, the payments may represent capital costs or other nondeductible costs which must be capitalized. I.R.C. §§162(c) and 263. See, also, I.R.C. §§709 and 195.

B. Transactions between related persons.

1. Matching of certain expenses.

a. General rule: In the case of expenses and interest, section 267 requires an accrual method partnership to take a deduction for expenses or interest paid to cash method partners only when those partners include the payments in income. I.R.C. §267(a)(2).

b. Rationale: This rule ensures that there is a matching of income and expenses between a partnership and its partners.

i. Exceptions to section 267.

a. Section 707(c): To the extent a partner is required by section 707(c) to include a guaranteed payment in income for the year in which the partnership deducts the payment under its method of accounting, section 267(a)(2) does not apply. I.R.C. §267(e)(4).
b. Other: Section 267(a) also does not apply to certain re syndications of low-income housing projects. I.R.C. §267(e)(5).

c. Related parties: For purposes of section 267(a)(2), a partnership and each of its partners are related persons. I.R.C. §267(e)(1)(A) and (B). The scope of section 267 reaches beyond just the partners and the partnership. Any person related to a person or a partnership under section 707(b)(1) is also subject to the related party rules. I.R.C. §267(e)(1)(D).

2. Sales or exchanges of property to/from controlled partnerships.

a. General rule: Section 707(b) provides limitations on the character of gain and recognition of loss as a result of a sale or exchange of property between a person and a controlled partnership or between two partnerships that are controlled by the same persons.

i. 1986 change: Prior to the Tax Reform Act of 1986 (the "1986 Act"), sections 707(b)(1)(A) and 707(b)(2)(A) applied only to sales or exchanges of property between a partnership and partners owning, directly or indirectly, more than a 50 percent capital or profits interest in the partnership.

a. Expanded reach: The 1986 Act deleted the word "partner" and inserted the word "person." This change was intended to expand the scope of transactions subject to the limitations of section 707(b) by including not only partners of a partnership but also persons related to the partners pursuant to section 267. Thus, for example, a sale or exchange of property between a partnership and the spouse of a partner is subject to the limitations of section 707(b) if the interest ownership of the spouse exceeds 50 percent.

b. Watch section 267: The fact that sections 707(b)(1)(A) and (b)(2)(A) have been expanded to include persons related to a partner does not affect...
the applicability of Regs. §1.267(b)-1(b). These regulations treat transactions between a partnership and a nonpartner as a transaction between the nonpartner and the partners of the partnership. If the nonpartner and any of the partners are related parties pursuant to section 267(c), the loss disallowance rules under section 267(a) apply with respect to the portion of the sale treated as made between related parties.

b. Disallowance of losses.

i. General rule: No deduction is allowed for losses from the sale or exchange of property (other than an interest in the partnership), directly or indirectly, between:

a. A partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership (I.R.C. §707(b)(1)(A)); or

b. Two partnerships in which the same persons own directly or indirectly, more than 50 percent of the capital or profits interest. I.R.C. §707(b)(1)(B).

ii. Subsequent sale: However, if the transferee later sells the property at a gain, the gain may be offset by the amount of loss disallowed in the original sale. Therefore, the transferee will only recognize gain to the extent it exceeds the previously disallowed loss. I.R.C. §§707(b)(1) and 267(d).

c. Character of gain: If the sale or exchange results in the recognition of gain, the gain is considered to be ordinary income if the property in the hands of the transferee is not a capital asset, as defined in section 1221. I.R.C. §707(b)(2).

i. Significance: The 1986 Act repealed the section 1202 deduction for long-term capital gains recognized by individual taxpayers. As a result, capital gains are taxed at the same rate as ordinary income.
However, the characterization of the income is still important for purposes of the capital loss limitation rules. If the gain recognized is characterized as ordinary income, the transferor will not be entitled to use the gain to offset any capital losses incurred during the year pursuant to section 1211(b). Section 1211(b) permits capital losses for individuals to be deducted only to the extent of the taxpayers capital gains plus $3,000. I.R.C. §1211(b)(1) and (2).

d. Ownership interests: For purposes of determining ownership, the attribution rules of section 267(c) apply, except for section 267(c)(3). I.R.C. §707(b)(3).

i. Entity: A partnership interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. I.R.C. §267(c)(1).

ii. Family: An individual is considered as owning the partnership interest owned, directly or indirectly, by or for his (or her) family. I.R.C. §267(c)(2). An individual's family includes only brothers and sisters, spouse, ancestors, and lineal descendants. I.R.C. §267(c)(4).

VI. Partnership Distributions and Liquidations.

A. General concepts.


2. Liquidating distributions: In contrast, liquidating distributions generally reflect an entity approach to partnership taxation.

3. Exceptions.

a. Section 751(b) distributions: A disproportionate distribution of unrealized receivables or substantially appreciated inventory is treated in part as a current distribution of partnership assets and in part as an exchange of partnership property.
b. Section 736(a) payments: Payments made to a retiring partner in excess of that partner's share of partnership property are treated either as guaranteed payments or as a distributive share of partnership income.

   a. Liquidating distributions: The regulations define liquidating distributions as distributions in termination of a partner's entire interest in a partnership, whether in a single distribution or a series of distributions. Regs. §1.761-1(d).
   b. Current distributions: A current distribution is any distribution that is not a liquidating distribution.
      i. Amount: Current distributions may be either pro rata among all of the partners or disproportionate.
      ii. Relationship to income: Current distributions may be greater or less than partnership income for the year.

5. Asset character: Any distribution may be made in either cash or property or in some combination of the two.

B. Recognition of gain or loss on distribution.
   1. Recognition of gain or loss to the partner.
      a. Current distributions.
         i. General rule: No loss is ever recognized. I.R.C. §731(a)(2).
         ii. Measure of gain: Gain is recognized to the extent the amount of money received exceeds the basis of the partner's partnership interest immediately before the distribution.
         iii. Character: Any gain recognized is treated as capital gain from the sale or exchange of the partnership interest (unless section 751(b) applies). I.R.C. §§731 and 741.
b. Liquidating distributions.

i. General rule: Ordinarily, loss is not recognized. However, where no property other than cash, unrealized receivables, and inventory is distributed, loss will be recognized to the extent the basis of the partner's interest in the partnership exceeds the amount of money received plus the basis of the other property distributed. I.R.C. §731(a)(2).

ii. Measure of gain: Gain is recognized to the extent the amount of money received exceeds the basis of the partner's partnership interest immediately before the distribution.

iii. Character: Any gain recognized is treated as capital gain from the sale or exchange of the partnership interest (unless section 751(b) applies). I.R.C. §§731 and 741.

iv. Trap for the unwary: This provision may prove a trap for the unwary. Consider the partner who receives assets with a fair market value of $1 million in liquidation of his interest, which has a basis of $10 million. If the distributee receives only cash and inventory, the loss of $9 million is realized and recognized. Conversely, if he takes cash of $950,000 and section 1231 property that lacks a section 751 taint, the loss is deferred. Prudent planning requires a review of the asset mix prior to the liquidating distributions.

2. Recognition of gain or loss to the partnership: The distributing partnership ordinarily does not recognize gain or loss on a distribution. I.R.C. §731(b). However, gain or loss may be recognized if section 751(b) applies.

C. Basis of distributed property.


a. General rule: The basis of distributed property (other than money) generally is the same to the distributee partner as it was to the partnership (i.e., a carryover basis). I.R.C. §732(a)(1).

b. Limitation: The basis of the distributed property to the distributee partner cannot exceed the basis of his partnership interest as
reduced by any money distributed in the same transaction. I.R.C. §732(a)(2).

2. Liquidating distributions.
   a. General rule: Generally, the basis of property (other than money) distributed in liquidation of a partner's interest is equal to the basis of the partner's interest in the partnership, less any money distributed to the partner in the same transaction. I.R.C. §732(b).
   b. Limitation: However, where the only property distributed (other than money) is unrealized receivables and inventory, the distributee partner's basis in the property distributed is limited to the partnership's basis in the distributed items. See, B. 1. b. i., above, regarding loss recognition in this situation.

3. Allocation of basis among distributed assets.
   a. Unrealized receivables and inventory: The aggregate basis of the distributed assets is allocated first to unrealized receivables and inventory in proportion to the basis of each asset to the partnership. However, the basis of these assets to the partner may not exceed their basis to the partnership. I.R.C. §732(c)(1).
   b. Other distributed property: If the basis to be allocated among the distributed assets exceeds the basis of the distributed unrealized receivables and inventory, any remaining basis (as determined under sections 732(a) and (b)) is allocated among the other distributed property in proportion to the bases of these assets to the partnership. I.R.C. §732(c)(2).

D. Character of gain or loss on subsequent sale of distributed property.

1. Unrealized receivables: Gain (or loss) on the sale of unrealized receivables subsequent to the partner's receipt of them in a distribution from a partnership constitutes ordinary income (or loss), regardless of how long the receivables are held by the distributee partner. I.R.C. §735(a)(1).

2. Inventory: Gain (or loss) on the sale of inventory that was received in a distribution from a partnership is considered ordinary income or loss if the sale by the distributee partner occurs within five years of the distribution. I.R.C. §735(a)(2).
3. Other property: The character of gain or loss from the sale of any other property received in distribution from a partnership depends on the holding period and character of the property in the hands of the distributee partner. A partner's holding period of property distributed to him by a partnership generally includes the period the property was held by the partnership. I.R.C. §735(b).

E. Basis of distributee partner's interest.

1. Significance: This computation is only relevant in the context of a current distribution.
   
a. Computation: A partner's interest is first reduced by any cash received. If the partner still has basis after reduction for cash distributions, the partner's basis is reduced (but not below zero) by the basis of other property distributed, as determined in section 732(a). I.R.C. §733(2).

F. The treatment of liabilities in a distribution.

1. The equivalent of cash: A decrease in a partner's share of liabilities is treated as a distribution of cash. Therefore, a partner may recognize gain on a distribution of partnership property even if no actual cash is distributed. I.R.C. §752(b).
   
a. Examples: A partner's share of liabilities can decrease in several ways. For example, a limited partner's share of liabilities usually will decrease when nonrecourse liabilities are converted to recourse liabilities. Additionally, a partner's share of liabilities also may decrease upon admission of a new partner. In this case, the liability shares of all of the old partners generally will decrease. This may cause recognition of gain to the old partners and may even invoke the application of section 751(b), at least in the collective minds of the IRS. Rev. Rul. 84-102, 1984-2 C.B. 119.

2. Contributions of encumbered property: A liability to which a property is subject is treated as a liability of the owner of the property. I.R.C. §752(c). Thus, if a partner contributes property to the partnership that is subject to a mortgage or other liability, the partner will be considered as having received a cash distribution in an amount equal to the reduction in his share of the liability, as determined under Regs. §1.752-1(e).
a. Contributing partner: If a partner contributes property subject to liabilities to a partnership, the partner's basis in his partnership interest is reduced (but not below zero) by the amount of the liabilities assumed by the partnership. I.R.C. §§752(b) and 733.

i. Possible gain: If the amount of liabilities allocated to the other partners exceeds the contributing partner's basis for his interest in the partnership, the contributing partner will recognize gain to the extent of this excess. I.R.C. §731(a)(1).

b. Other partners: To the extent they are deemed to assume the contributing partner's liabilities, the other partners are treated as though they contributed money to the partnership. Thus, they are entitled to increase their respective bases by the amount of the deemed contribution. I.R.C. §§752(a) and 722.

c. Collateral consequences: If the contribution affects the other partners' profit and loss interest, their individual shares of partnership liabilities may also change. As a consequence, two results may occur:

i. Partners whose shares in the partnership profits and losses increase are considered to have contributed cash and are entitled to a basis increase. I.R.C. §§752(a) and 722.

ii. Partners whose shares decrease are treated as having received cash distributions from the partnership. I.R.C. §752(b).

3. Distributions of encumbered property: A distribution of encumbered property to a partner is treated as both a distribution of cash to all partners sharing in the liability and a contribution of cash by the distributee partner in an amount equal to the liability secured by the property. I.R.C. §§752(a) and (b). The distribution and contribution are deemed to occur simultaneously. Rev. Rul. 79-205, 1979-2 C.B. 255.

a. Significance: Absent this timing rule, any distribution of encumbered property conceivably could result in the recognition of gain to the partner receiving the property subject to the liability.
Partnership terminations: A similar result occurs when more than one encumbered asset is distributed in a technical termination of a partnership. In this case, as long as the assets are distributed as part of a single transaction within one taxable year, all section 752(b) distributions and section 752(a) contributions are deemed to occur simultaneously, even if the encumbered assets are distributed among the various partners. Rev. Rul. 87-120, 1987-2 C.B. 161.

VII. An Overview of Section 751(b): The "Hot Asset" Rules.

A. General rules.

1. Sale or exchange: Money or other property received in exchange for all or a part of an interest in a partnership that is attributable to either "unrealized receivables" or "substantially appreciated inventory" is considered to be an amount realized from the sale or exchange of the underlying tainted receivables or inventory. I.R.C. §751(a).

2. Non pro rata distributions: If a partner receives a distribution of partnership property in liquidation of all or a portion of his partnership interest, and the property received does not constitute a pro rata share of the partner's interest in unrealized receivables and substantially appreciated inventory, as well as other partnership property, the distribution will be treated as a sale or exchange between the distributee partner and the partnership of the non pro rata portion of the distribution. I.R.C. §751(b).

B. Application of section 751(b).

1. When does section 751(b) apply?: The partnership must hold unrealized receivables or substantially appreciated inventory (so-called "hot assets" or "section 751 assets").

2. Deemed exchange: The distributee partner must receive hot assets in exchange for other property, or other property in exchange for his share of partnership hot assets. Thus, an exchange occurs only if the distributee's interest in the value of one class of partnership property is increased and his interest in the value of the other class is decreased.
C. Exceptions to section 751(b).

1. Section 736(a): Liquidating distributions.

2. Self-contributed property: Distributions of property contributed by the distributee.

3. "Nondistributions": Drawings, advances, gifts, and payments for services or for the use of capital. Regs. §1.751-1(b)(1)(ii).

D. Effect of section 751(b).

1. Increase in distributee's interest in section 751(b) property.
   a. Deemed exchange: The excess section 751 property is treated as acquired by the distributee in exchange for his surrender of a portion of an interest in the partnership's "other property."
   b. Recognition event: Both the distributee partner and the partnership may recognize gain. The distributee's gain generally will be capital gain, while the partnership's gain generally will be ordinary income. All "exchanged" assets have a cost basis to the recipient.
   c. Other rules apply: The balance of the property actually received by the distributee is treated as received in a distribution subject to sections 731-735.

2. Increase in distributee's interest in other property.
   a. Deemed exchange: The excess "other property" is treated as received or acquired by the distributee in exchange for his surrender of a portion of an interest in section 751 property.
   b. Recognition event: The exchange generally produces ordinary income to the distributee partner, who is viewed as disposing of a portion of his interest in section 751 property, and capital gain (or loss) to the continuing partnership, which is viewed as transferring the excess "other property" to the distributee in a taxable exchange.
   c. Other rules apply: The remainder of the property actually distributed is subject to the general distribution provisions of sections 731-735.
E. The seven step analysis of section 751(b).

1. Classify the partnership assets.
   a. First class: Unrealized receivables and substantially appreciated inventory constitute one class.
   b. Second class: A second class is composed of all other property.
   c. Only one class: If the partnership has only one class of property, section 751(b) is inapplicable.

2. Determine the gross value of the distributee's interest in each asset.
   a. Pre-distribution: Determine the gross value of the distributee's pre-distribution interest in each partnership asset in each class. The gross value is the value before reduction for liabilities to which the assets are subject.
   b. Post-distribution: Determine the gross value of the distributee's post-distribution interest in each undistributed partnership asset in each class. In the case of a complete liquidation, this would be zero.
   c. Partner share: Determine the gross value of all property actually distributed to the partner.
   d. "Vanilla" allocations: If the distributee has the same percentage interest in partnership profits, losses and capital, his share of the value of each class of property is simply his percentage interest in the partnership multiplied by the gross value of the property in each class.

3. Determine the partnership exchange table.
   a. Comparison: Compare the distributee's pre-distribution interest in the value of each asset class with the sum of: (1) The value of the distributee's post-distribution interest in the undistributed assets in each class; and (2) The value of the assets in each class actually received by the distributee.
   b. Result: This comparison reveals whether the distribution results in an exchange of assets of one class for assets of the second class. The asset class from which the partner has received
an excess distribution is referred to as the "purchased class." The asset class from which the partner has received a disproportionately small distribution is called the "relinquished class."

c. If an exchange results, the comparison also reveals the value of the assets involved in the exchange.

d. Liabilities.
   i. Reduction: A reduction in liabilities due to a section 752(b) constructive cash distribution is considered to be a distribution of other property (i.e., cash).
   
   ii. Assumption: If the distributee assumes partnership liabilities in connection with the distribution, or receives property subject to partnership liabilities, the amount of liabilities assumed or taken subject to must be subtracted from the amount of constructive cash distribution so that only the net reduction in the distributee's liabilities is accounted for in the comparison.

4. Determine which assets are involved in the section 751(b) exchange.

   a. Determine which assets are "sold" by the distributee.
      
      i. General rule: Generally, the distributee is treated as selling a proportionate amount of each asset in the relinquished class in which he had an interest.
      
      ii. If the distributee receives an actual distribution of more than his share of a partnership asset in the relinquished class, the distributee is treated as having received it in exchange for other assets in the relinquished class. This exchange has no tax consequences since only exchanges between classes are taxable under section 751(b).

   b. Determine which assets are "purchased" by the distributee.
      
      i. General rule: Generally, the distributee is treated as "purchasing" the excess of the assets of the purchased class received
over the proportionate share of each asset in the purchased class.

ii. Although the distributee may acquire more than a proportionate share of some of the assets in the purchased class, he may have acquired less than his share of other assets in the purchased class. Since section 751(b) applies only to exchanges between classes, the exchange of assets within a particular class of assets is ignored. Only the net excess amount of the assets in the purchased class is treated as having been purchased.

5. Determine the basis of the relinquished assets.
   a. Deemed distribution: The relinquished assets are treated as having been received by the distributee in a fictional current distribution immediately before the exchange.
   b. Basis: The distributee's basis in these assets is generally the same as their basis in the hands of the partnership. I.R.C. §732(a)(1).
   c. Caveat: The basis limitation and allocation rules of section 732(a)(2) and (c) may come into play.

6. Consequences of the section 751(b) exchange.
   a. Recognition of gain or loss.
      i. The distributee: The section 751(b) exchange is a taxable event in which the distributee recognizes gain or loss under section 1001 equal to the difference between the value of the property received in the exchange (i.e., the purchased property) and the basis in the relinquished assets.
      ii. The partnership: Similarly, the partnership recognizes gain or loss under section 1001 equal to the difference between the value of the property received in the exchange and its basis in the assets that it relinquishes.
      iii. Continuing partners: Gain or loss recognized by the partnership is allocated among the partners (other than the distributee) in accordance with their relative post-distribution interests in
partnership profits or losses and is separately stated as a section 702(a)(7) item. Regs. §1.751-1(b)(2)(ii).

iv. Loss: A loss realized in the section 751(b) exchange is fully recognized, even if section 707(b)(1)(A) would otherwise preclude such recognition. Regs. §1.751-1(b)(1)(i).

b. Character of gain or loss recognized.
   i. "Sale" of section 751 property.
      a. The distributee: The character of the gain or loss recognized by the distributee is ordinary income or loss.
      b. The partnership: The gain or loss recognized by the partnership generally is capital gain or loss, as determined by reference to the character of the assets deemed to be sold by it.

ii. "Sale" of other property.
      a. The distributee: The character of gain or loss recognized by the distributee is determined by reference to the character of the property which he relinquished in the exchange.
      b. The partnership: The gain or loss recognized by the partnership is ordinary income or loss.

   c. Timing of gain or loss recognition: Generally, gain or loss realized by the distributee and the partnership in a section 751 exchange must be recognized immediately.

7. Treatment of the portion of the distribution not included in the section 751 exchange: These assets are treated as in a normal distribution. Consequently, their treatment is determined under the general rules for distributions of sections 731 through 735.
VIII. Tax Year of Partners and the Partnership.

A. When a partner includes partnership income.

1. General rule: A partner must include in income his distributive share of partnership items and guaranteed payments for the taxable year of the partnership that ends within or with the partner's taxable year. I.R.C. §706(a).

2. Constructive distribution: Section 706(a), in effect, deems a distribution of these items to occur when the partnership's taxable year ends.

3. Example: X, a calendar year taxpayer, is a partner in XYZ partnership, which has a June 30 year end. (Assume for purposes of this example that section 706(b) allows the partnership a June 30 taxable year end.) Thus, partner X would report on his 1988 Federal income tax return his distributive share of partnership items for the partnership year ending June 30, 1988. X does not have to recognize in 1988 his share of partnership items for the period from July 1 to December 31, 1988 (which are reported on the partnership's return for its year ending June 30, 1989). Rather, X will include his share for that period on his 1989 return.

   a. Deferral benefit: The potential value of this six month deferral has not gone unnoticed by the Congress. The limitations on a partnership's selection and retention of a taxable year are discussed immediately below.

B. Partnerships: Permissible taxable years.

1. General rule: A partnership adopts a taxable year as if it were a taxpayer. I.R.C. §706(b)(1)(A). However, its selection and retention of a taxable year is subject to the limitations discussed below. I.R.C. §706(b).

2. Limitations: Section 706(b)(1)(B), as amended by the 1986 Act, severely limits the ability of a partnership to adopt or retain a tax year other than the tax year of its majority partners. Section 706(b)(1)(B) provides a priority pyramid, so that a partnership may not have a taxable year other than:

   a. Majority partners: The taxable year of one or more of its partners who have an aggregate interest in partnership profits and capital of greater than 50 percent;
b. Principal partners: If there is no common tax year among partners owning greater than 50 percent of partnership profits and capital, the taxable year of all of its principal partners (defined as partners with a five percent or more interest in partnership capital or profits); or

c. Default: If the principal partners do not all have the same tax year, the partnership must adopt a calendar year as its tax year unless a different period is prescribed either in the regulations promulgated under section 706 or is allowed by the IRS.

i. Least aggregate deferral: If the principal partners do not have the same tax year, and no majority of partners have the same tax year, the partnership must adopt the tax year of one or more of the partners that results in the least aggregate deferral of income to the partners. Temp. Regs. §1.706-1T.

ii. Definition: The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the months of deferral (measured from the end of the partnership's tax year forward to the end of the partner's tax year) for each partner and each partner's interest in partnership profits. The partner's tax year which produces the lowest sum when compared to the other partners' tax years is the tax year that results in the least aggregate deferral.

d. "Business purpose" exception: A partnership may adopt or retain an otherwise nonpermissible year if it establishes, to the satisfaction of the Secretary, a business purpose for that taxable year. I.R.C. §706(b)(1)(C).

e. "Enhanced estimated payments" exception: Within certain limitations, a partnership may adopt or retain other than a required year if it agrees to make certain "required payments." I.R.C. §§444 and 7519.

3. Application: Section 706(b), as amended by the 1986 Act, generally applies to tax years beginning after December 31, 1986 (and not simply to partnerships formed after 1986). Thus, the amendments affect both newly formed and existing partnerships.
a. Existing partnerships: An existing partnership with a nonconforming year (e.g., a partnership with only individuals as partners which adopted a fiscal year ending on September 30, October 31, or November 30, as allowed under prior law by Rev. Proc. 72-51, 1972-2 C.B. 832) generally must have changed to a permitted year for its first tax year beginning after December 31, 1986. The change required a short taxable year return to conform the partnership's year to a permitted year. Partners in a partnership required to change its year end under new section 706(b) are entitled to relief since the change resulted in more than 12 months of partnership income otherwise included in the partners' 1987 income tax returns. The relief provision, section 806(e)(2) of the 1986 Act, provides that:

i. Taxpayer initiated: The required change in the partnership's year end shall be treated as initiated by the taxpayer;

ii. Consent: The change will be treated as having been made with the consent of the Secretary; and

iii. Timing of the adjustment: With respect to any partner required to include income from more than one year of the partnership in one taxable year, income in excess of expenses for the short taxable year of the partnership shall be taken into account ratably in each of the first four taxable years of the partner (including the short taxable year) beginning after December 31, 1986, unless the partner elects to include all income from the short period in the short taxable year.

a. Basis increase: Any income of the partnership for the short year increases the partner's basis immediately, even though the partner includes the short period income in his (or her) individual income tax return over a four year period. Temp. Regs. §1.702-3T(e).

iv. Dispositions: The effect of a disposition of all or part of a partnership interest to which the four year spread applies is determined by the amount of the interest retained by the disposing partner. Temp. Regs. §1.702-3T(g)(1).
a. If less than or equal to one-third of the interest held in the year of change is retained, all of the unamortized adjustment is recognized in the year of disposition.

b. If greater than two-thirds is retained, the unamortized adjustment continues to be recognized ratably over the four year period.

c. Finally, if greater than one-third but less than or equal to two-thirds is retained, a ratable portion of the unamortized adjustment plus one-half of the remaining balance is recognized in the year of disposition. Temp. Regs. §1.702-3T(g)(2).

4. Business purposes and the retention or adoption of other fiscal years.

a. General rule: As noted above, a partnership may retain or adopt an otherwise nonpermissible fiscal year if it establishes, to the satisfaction of the Secretary, a business purpose for the year.

b. IRS guidance: The Service has issued temporary regulations regarding the adoption of partnership taxable years. Temp. Regs. §1.442-3T. The temporary regulations generally are effective only for partnerships whose first taxable year began before 1987, but should provide some guidance regarding the Service's eventual position regarding adoption or retention of partnership taxable years for subsequent years. Following the legislative history of the 1986 Act, the regulations provide that the following factors generally will not be sufficient to establish a substantial business purpose:

i. The use of a particular year for regulatory or financial accounting purposes;

ii. The hiring patterns of a particular business (e.g., the fact that a firm typically hires staff during certain times of the year);

iii. The use of a particular year for administrative purposes, such as for admission or retirement of partners, promotion of staff, and compensation or
retirement arrangements with staff, or partners; and

iv. The fact that a particular business involves the use of price lists, model year, or other items that change on an annual basis. Temp. Regs. §1.442-3T(c)(2). See, e.g., Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (the "1986 General Explanation"), at 537.

c. Procedure: Rev. Proc. 87-32, 1987-2 C.B. 396, provides expeditious approval provisions for any partnership desiring to retain or change to a tax year that coincides with a natural business year. Special notification provisions are also provided for any partnership that intends to adopt, retain or change its tax year as required by the 1986 Act, and for any partnership that wants to retain a "grandfathered" fiscal year. The revenue procedure also includes instructions for adopting, changing or retaining a tax year by establishing a business purpose.

i. Elements: Under Rev. Proc. 87-32, supra, a partnership establishes a business purpose for the use of a requested tax year if: (1) The tax year is a natural business year; and (2) Certain other conditions are met.

ii. Natural business year: A natural business year is determined by a 25 percent test, determined as follows: Compute gross receipts from sales and services for the most recent 12-month period ending before the request is filed and that ends with the last month of the requested fiscal year. Divide this amount by the gross receipts from sales and services for the last two months of the 12-month period. Then repeat the same computation for the two 12-month periods preceding the period computed above. If each of the three results is at least 25 percent, then the requested fiscal year is the natural business year. If the partnership qualifies for more than one natural business year, the fiscal year producing the highest percentage is used.

d. Legislative history: The legislative history of the 1986 Act also provides useful guidance regarding what will or will not constitute a business purpose.
i. Income deferral: A deferral of income to the partners does not constitute a business purpose. I.R.C. §706(b)(1)(C). Under prior law, Rev. Proc. 72-51, supra, provided that partnerships generally could adopt a year which provided a three month or less deferral of income (e.g., a September, October, or November year end where all the partners are individuals). However, under the 1986 Act, the deferral of income for a limited time to the partners, such as the three months rule of Rev. Proc. 72-51, supra, is not to be treated as a business purpose. Conference Committee Report, Tax Reform Act of 1986 (H.R. 3838), H. Rep. No. 861, 99th Cong., 2d Sess. (the "Conference Report"), II-318.

ii. Prior approval: Partnerships that received permission to use a fiscal year end (other than a year end that resulted in a three month or less deferral of income) under the provisions of Rev. Proc. 74-33, 1974-2 C.B. 489, will be allowed to continue such year without obtaining approval of the Secretary. Conference Report, supra, II-319.

C. Use of a nonpermitted year.

1. General rule: Under the 1987 Act, a partnership that does not meet the business purpose test may nevertheless elect a fiscal year, within certain limitations, providing the partnership agrees to make a "required payment", due in a single installment each May 15th. Temp. Regs. §1.7519-2T(a)(4)(ii).

2. Benefits and detriments: There are several situations in which a section 444 election may economically advantageous or disadvantageous to a taxpayer.

   a. Proportionality: The calculation of a required payment under section 7519 for a partnership assumes proportionality (i.e., a proportional amount of the year's income is earned in the deferral period). Therefore, if a partnership earns a disproportionately large amount of its income in the "deferral period," a section 444 election will generally be advantageous.

   b. Income trend: The required payment is computed using prior years' income. Therefore, if the partnership is experiencing a growth trend, the
required payment will usually be less than the amount of tax paid if the partnership changes to its required year.

c. Rate arbitrage: A cash flow benefit can be attained if the partners are in a 33 percent bracket for years after 1987. Under Temp. Regs. 1.7519-1T(b)(2)(i), the rate used in computing the required payment for applicable election beginning after 1987 is computed using a 29 percent rate.

d. Compliance burden: These savings must be weighed against the administrative costs of adhering to the rules under section 7519. It should be noted that taxpayers in the situations opposite of those above (e.g., where an entity's business is declining or a disproportionately small amount of income is earned in the deferral period) will suffer economically from making the section 444 election.

3. Election: Both the election of other than a required year under section 444 and the required payment of section 7519 are made at the entity level, rather than by or on behalf of the partners. The election does not require IRS approval and, once made, is valid for all future years until either revoked or terminated. I.R.C. §444(d)(2)(A).

a. Failure to pay: If the electing partnership does not make the required payment, the IRS may terminate the election. I.R.C. §7519(f)(4)(C); Temp. Regs. §1.444-1T(a)(5)(i)(C).

b. Revocation: The electing partnership may revoke its election at any time without the permission of the IRS, in which case the partnership must then change to a permitted year. I.R.C. §444(d)(2)(A); Temp. Regs. §1.444-1T(a)(5)(i)(A).

c. Subsequent election: An electing partnership whose election has been either revoked or terminated cannot re-elect a fiscal year under these provisions. I.R.C. §444(d)(2)(B); Temp. Regs. §1.444-1T(a)(5)(i).

4. Deferral period — Adoption of a year: Generally, a partnership may not adopt a fiscal year that results in a deferral to the partners of more than three months. Thus, if the partnership is otherwise required to use a calendar year, it generally may adopt a September 30, October 31, or November 30 year end. I.R.C. §444(b)(1); Temp. Regs. §1.444-1T(b)(1).
5. Deferral period -- Change of a year: If the partnership is changing its year end, it may change to a taxable year resulting in a deferral period of the lesser of: (1) Three months; or (2) Its current deferral period. Thus, a partnership with an October 31 fiscal year (under section 706 prior to its amendment by the 1986 Act) and a required year of December 31 could change to a November 30 year but not a September 30 year end. I.R.C. §444(b)(2); Temp. Regs. §1.444-1T(b)(2)(i). This rule generally prohibits existing partnerships on a calendar year from changing to some other year.

6. Transitional rules: Special transitional rules apply to a partnership that wished to retain a fiscal year for its first taxable year beginning after 1986. These rules applied to an entity that would have been required to change to a calendar year in 1987 under section 806 of the 1986 Act. The partnership is allowed to retain its fiscal year, even if it results in a deferral period of more than three months. Temp. Regs. §1.444-1T(b)(3).

7. Tiered structures: A partnership that is part of a tiered structure generally cannot make a section 444 election unless the tiered structure is composed solely of S corporations and/or partnerships (but not personal service corporations) and all of the entities have the same taxable year. Temp. Regs. §§1.444-2T(e) and 1.444-2T(f), Example 8.

8. Required payment: If a partnership elects a fiscal year under section 444, it must make a required payment under section 7519. This payment is in the nature of a deposit by the partnership. The required payment essentially is intended to approximate the benefit of tax deferral resulting to the partners which results from the use of the elected fiscal year. The required payment is not a deductible expense of either the partners or the partnership, nor may the partners claim it as a credit against their individual tax liabilities.

a. Calculation: The payment is calculated at a "tax rate" of 36 percent for base years ending in 1987 and at the highest individual statutory rate plus one percent (currently 29 percent) in the following years. I.R.C. §7519(b); Temp. Regs. §1.7519-2T(b)(2)(i). This deposit percentage of the section 1 tax rate plus one percent applies even if the partners are all C corporations otherwise subject to the rate of tax imposed by section 11.
b. Phase-in of the payment: There is a four-year phase-in of the amount of the required payment, which generally corresponds to the four-year income spread under section 806(e)(2) of the 1986 Act. I.R.C. §7519(d). The phase-in is available to all partnerships, and not just those whose partners would have been entitled to the four-year income spread of the transition rule of the 1986 Act. Temp. Regs. §1.7519-1T (b)(1)(i) and (ii). (However, section 204(d) of the pending Technical Corrections Bill of 1988 would eliminate the phase-in after 1987 for those partnerships whose partners would not have been entitled to the four-year spread.)

c. Threshold amount: A partnership does not have to make a required payment if the total of required payments for the current and all preceding election years does not exceed $500. I.R.C. §7519(a)(2); Temp. Regs. §1.7519-1T(a)(2).

d. No payment: A partnership has no obligation to make required payments if it uses a year for which it has established a business purpose or uses a grandfathered fiscal year. Temp. Regs. §§1.7519-1T(a)(1) and 1.444-1T(a)(3).

9. Computation of the payment: In general, the calculation of the required payment under section 7519 for any year in which the section 444 election is in effect is made as follows:

a. Multiply the partnership's net income from the preceding fiscal year (the "base year") by a ratio, the numerator of which is the number of months in the deferral period and the denominator of which is the total number of months in the base year (usually 12);

b. Multiply the result in a., above, by the statutory rate (36 percent for base years ending in 1987, 29 percent thereafter);

c. Multiply the result in b., above, by the four-year phase-in factor (25 percent for years beginning in 1987, 50 percent for years beginning in 1988, 75 percent for years beginning in 1989 and 100 percent for years beginning in 1990 or later); and

d. Subtract the cumulative balance of all previous required payments for prior years from the result obtained in c., above. Temp. Regs. §1.7519-1T(a)(3)(i) and (ii).
10. "Applicable payments": If the partnership makes payments to its partners that are includible in their income (e.g., salary, rent, etc.), the required payment formula must include an additional element that effectively spreads these payments (called "applicable payments") equally over the fiscal year. I.R.C. §7519(d). Applicable payments do not include the gain from the sale or exchange of property between a partner and the partnership or guaranteed payments under section 707(c). I.R.C. §7519(d)(3)(B); Temp. Regs. §1.7519-1T(b)(5)(iv)(B). This component is computed as follows:

a. Multiply the total applicable payments made during the base year by the ratio referred to in 9. a., above, and subtract the actual applicable payments made during the deferral period of the preceding year (the "base year");

b. Multiply the result in a., above, by the statutory rate;

c. Multiply the result in b., above, by the four-year phase-in factor; and

d. Subtract the cumulative balance of the applicable payment component for all previous years from c., above.

11. Total: The combination of the deferred base year net income component calculated in 9., above, and the applicable payment component calculated in 10., above, equals the total required payment.

12. Reduction in the required payment: If the calculation of the required payment for a year results in a negative amount, the partnership is entitled to a refund of that amount. I.R.C. §7519(c). Additionally, a refund may be obtained for the total cumulative payment in the year the partnership revokes its section 444 election. Temp. Regs. §1.7519-1T(c). However, no interest will be paid on any refunds of section 7519 payments. §7519(f)(3); Temp. Regs. §1.7519-2T(a)(6)(iii).

13. Compliance aspects of the election: An election under section 444 generally must be made by the earlier of: (1) The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will take effect; or (2) The due date (without regard to extensions) of the income tax return resulting from the section 444 election. Temp. Regs. §1.444-3T(b)(1). (However, in no instance was the
filing date before July 26, 1988.) Temp. Regs. §1.444-3T(b)(2).

a. Form of the election: The election is made by filing Form 8716, Election to Have a Tax Year Other Than a Required Tax Year, with the Service Center indicated in the instructions to the form. Temp. Regs. §1.444-3T(b)(1).

i. Duplicate filing: A copy of Form 8716 must be attached to Form 1065 for the first year for which the election is made. Temp. Regs. §1.444-3T(b)(1).

ii. Signature: Form 8716 must be signed by a person authorized to sign the partnership return. Temp. Regs. §1.444-3T(b)(1).

b. Tax return due dates: The temporary regulations extended the original due date of a return that results from making a section 444 election (for the first taxable year that began after December 31, 1986), to August 15, 1988, if later. (A request to extend the original due date was not required). However, the wording "Section 444 Return," should have been typed or legibly printed at the top of the Form 1065. Temp. Regs. §1.444-3T(c)(1).

c. Form and timing of payments: For applicable election years beginning after 1987, payments are made with Form 720, Quarterly Federal Excise Tax Return, unless another form is prescribed by the Commissioner and are due on or before May 15 of the calendar year following the calendar year in which the applicable election year begins. Temp. Regs. §§1.7519-2T(a)(2)(i) and 1.7519-2T(a)(4)(ii).

14. Tiered structures: Section 444(d)(3) generally prohibits an entity which is part of a "tiered structure" from making an election under section 444 to retain or adopt a taxable year other than its required year.

a. Definition: A partnership is a part of a tiered structure if it directly owns any portion of a "deferral entity" or a deferral entity directly owns any portion of it. A deferral entity is defined as an entity which is a partnership, S corporation, personal service corporation, or trust. Temp. Regs.§1.444-2T(b)(2)(i). A grantor trust or qualified Subchapter S trust is not included in the definition. Temp. Regs. §1.444-2T(b)(2)(ii).
b. Exceptions: There are two significant exceptions under which a partnership may make an election under section 444, notwithstanding an ownership relationship with a deferral entity: (1) The de minimis exception; and (2) The "same taxable year" exception. These exceptions are described briefly below.

i. De minimis exception: Irrespective of the general prohibition of an ownership relationship between an entity electing under section 444 and a deferral entity, certain de minimis amounts of ownership will not cause an entity to be considered a member of a tiered structure. If a partnership owns an interest in one or more deferral entities, and in the aggregate those deferral entities do not account for more than five percent of the partnership's adjusted taxable income and two percent of its gross income, then the ownership is disregarded for purposes of the tiered structure definition. Temp. Regs. §1.444-2T(c)(2)(i).

a. If one or more deferral entities owns a portion of a partnership and, in the aggregate, that ownership is five percent or less of the current profits of the partnership, then this ownership is also disregarded for purposes of the tiered structure definition. Temp. Regs. §1.444-2T(c)(3).

b. Each entity that falls under the general definition of a tiered structure must be considered separately for purposes of the de minimis exception. For example, a personal service corporation may own an interest in a partnership that is considered de minimis to the partnership, but not the PSC. Therefore, while the partnership would be allowed an election under section 444, the PSC would not.

ii. Same taxable year: In general, if a tiered structure is composed entirely of S corporations, partnerships or both (but not PSCs), all of which are on the same taxable year, then the entities in that structure may make an election under section 444 to retain that year. However, for purposes of
this rule, there is a special definition of a tiered structure and provisions that govern the interaction of the same taxable year exception with the de minimis rule. Temp. Regs. §1.444-2T(e)(5). Two or more entities are considered to have the same year if their taxable years end on the same day, even though they begin on different days. This rule allows certain S corporations or partnerships to change their years to qualify for this exception. Temp. Regs. §§1.444-2T(e)(3) and 1.444-2T(f), Example (11).

D. Changes in a partner's taxable year.

1. General rule: Section 706 prohibits a principal partner from changing his taxable year to any year other than the partnership's taxable year unless the partner establishes a business purpose for the change. I.R.C. §706(b)(2).

2. Reach of the rule: The Commissioner's consent is required for any change in a partner's taxable year. This rule applies to all partners and not just principal partners. Regs. §1.706-1(b)(2).

IX. Considerations in Using a Tiered Partnership Structure.

A. Terminology: In its simplest form, an "upper-tier" partnership (also called a "parent" or "investing" partnership) invests in the "lower-tier" partnership (sometimes referred to as a "subsidiary" or "operating" partnership), which, in turn, owns the operating assets of the group.

B. Business and tax considerations.

1. In general: A tiered partnership structure may offer a number of business advantages. For example, the owners can almost accomplish the Subchapter K equivalent of a holding company structure, isolate liability exposure through the tiering of limited partnership interests, and obviate the need for amending state law limited partnership filings.

2. Other forms of tiered ownership: The use of a tiered structure is not limited only to a chain of partnerships. For example, the Internal Revenue Service has respected a partnership composed of subsidiaries of the same parent corporation. Rev. Rul. 75-19, 1975-1 C.B. 382. Additionally, the partners in a partnership may consist of S
corporations, each of which is wholly-owned by a different individual or group of individuals.


b. Planning: Assuming the caveat of Rev. Rul. 77-220, supra, is not problematic, the structure of a partnership including one or more S corporations creates a series of creative planning possibilities. For example, the partnership agreement can contain special allocations that would not be possible in a simple S corporation because of the one class of stock limitation. I.R.C. §1361(b)(1)(D). Such a tiered structure also may create estate planning possibilities not otherwise available to the S corporation shareholder (subject, of course, to the valuation freeze rules of section 2036(c)).

c. Federal income tax considerations: The use of a tiered partnership structure involves a series of additional Subchapter K considerations, including:

1. A partner's share of partnership liabilities: A limited partner's basis for his (or her) interest in a first tier limited partnership includes that partner's share of the second tier partnership's nonrecourse liabilities which are allocated to the first tier partnership. Rev. Rul. 77-309, 1977-2 C.B. 216.

2. Availability of other than a permitted year: See the discussion at VIII. C. 14., above for limitations on the taxable year of a partnership that is part of a tiered structure.

3. Partnership terminations due to changes in ownership: The sale of an interest in an upper-tier partnership which results in a termination under section 708(b)(1)(B) will cause the upper-tier partnership to be deemed to have distributed all of its assets to its partners. If one of the assets distributed is a 50 percent partnership interest in a lower-tier partnership, that distribution will cause the termination of the lower-tier partnership, as the upper-tier partnership is treated as having exchanged its entire partnership interest. Rev. Rul. 87-50, 1987-1 C.B. 157. See, Rev. Rul. 87-51, 1987-1 C.B. 158, which holds that the sale of an interest in an
upper-tier partnership which does not cause that partnership to terminate does not result in a sale of an interest in a lower-tier partnership which could cause the termination of the lower-tier partnership.

4. Section 754 elections:

a. Distribution of a partnership interest: No section 734(b) adjustment is allowed unless the distributor partnership and the partnership whose interest is distributed both have section 754 elections in effect. I.R.C. §734(b) (last sentence).

b. Upper-tier and lower-tier partnership each have a section 754 election in effect: A sale or exchange of an interest in a partnership which is also a partner in a partnership results in a section 743 adjustment to both partnerships (i.e., it flows through) if both partnerships have a section 754 election in effect. Rev Rul. 78-2, 1978-1 C.B. 202.

c. Only the upper-tier partnership has a section 754 election in effect: If the upper-tier partnership has a section 754 election in effect but the lower-tier partnership does not, the purchase of a partnership interest in the upper-tier partnership will adjust the basis of the upper-tier partnership's assets, but will not affect the lower-tier partnership's adjusted basis in its property. Rev. Rul. 87-115, 1987-2 C.B. 163.

d. Only the lower-tier partnership has a section 754 elections in effect: If the lower-tier partnership has a section 754 election in effect but the upper-tier partnership does not, the purchase of a partnership interest in the upper-tier partnership will not lead to any inside basis adjustments. Rev. Rul. 87-115, 1987-2 C.B. 163.

5. Flow through of partnership items: Lower-tier partnerships in a multiteried structure must separately state those items of income, gain, loss, deduction, and credit which if separately taken into account by any partner of any partnership in the multiteried structure would result in an income tax liability for that partner different from that which would result if that partner did not take those items into account separately. Rev. Rul. 86-138, 1986-2 C.B. 84.
6. Retroactive allocations: To prevent the use of tiered partnerships to avoid the retroactive allocation rules, an upper-tier partnership's share of any item of income, gain, loss, deduction, or credit of a lower-tier must be prorated equally over that portion of the taxable year during which the upper-tier had an interest in the lower-tier. I.R.C. §706(d)(3).

X. **Selected Compliance Considerations.**

A. **Foreign partnership compliance.**

1. Partner filings.
   
   a. The Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Act") added the requirement that United States persons who are partners in foreign partnerships file a return if:
      
      i. They acquire any interest in a foreign partnership,

      ii. They dispose of any portion of their interest in a foreign partnership, or

      iii. Their proportional interest in a foreign partnership changes substantially. I.R.C. §6046A(a).

   b. Guidance: The Service has not provided regulatory guidance as to the information or form to be filed and has extended the time to file the required returns. Announcement 83-5, 1983-2 I.R.B. 31.


3. Section 754 election: The U.S. person that seeks to avail itself of a section 754 election from the acquisition of an interest in a foreign partnership needs to exercise a degree of planning. If the foreign partnership fails to satisfy its compliance obligation vis-à-vis the U.S. partner, it falls upon the U.S. partner to satisfy, in English, all the section 754 disclosures. Failure to disclose in English the election and the corresponding basis adjustments on the U.S. partner's return has been held as grounds to disallow the basis adjustments. Atlantic Veneer Corp. v. Commissioner, 85 T.C. 1075
B. Withholdings on distributions to foreign partners.

1. Income: A domestic partnership is required to withhold 30 percent of fixed or determinable annual or periodic income which is included in a foreign partner's distributive share. I.R.C. §§1441 and 1442.

2. Real property: Where a partnership holds a U.S. real property interest ("USRPI"), it is required to withhold 34 percent of the gain realized on the disposition of the USRPI which is included in a foreign partner's distributive share (under section 1445(e)(1)) or 10 percent of the value of a USRPI distributed to a foreign partner in a taxable distribution under section 897. I.R.C. §1445(e)(4).
   a. Sale of an interest: Where a partnership interest is sold by a foreign partner and the underlying partnership assets include a U.S. real property interest, the transferee is required to withhold 10 percent of the amount realized. I.R.C. §1445(e)(5).

3. Other distributions: A partnership must withhold 20 percent of amounts distributed to a foreign partner on income which is effectively connected with the conduct of a U.S. trade or business. I.R.C. §1446.

C. Reporting requirements associated with the transfer of a partnership interest.

1. Exchanges of partnership interests described in section 751(a): A partnership is required to file Form 8308, Report of Sale or Exchange of Certain Partnership Interests, with its partnership return to notify the Service of any exchange described in section 751(a) of any of its interests during the calendar year which ends during the partnership's taxable year. I.R.C. §6050K.

   a. Statements furnished by partnership to transferor and transferee: The partnership is also required to provide a written statement to the transferee and transferor of its partnership interest in a section 751(a) exchange on or before January 31 of the calendar year following the calendar year in which the transfer occurred or, if later, 30 days after the partnership is notified of the transfer.
i. Form of statement: The partnership must use the completed Form 8308 unless the Form 8308 contains information with respect to more than one section 751(a) exchange. If Form 8308 is not used the statement must include all information shown on Form 8308 with statements indicating that the information has been provided the I.R.S. and other reporting requirements.

b. Partnership's notification: The partnership is not required to file Form 8308 until it receives notification of a transfer of one of its interests. I.R.C. §6050K(c)(2).

i. The partnership is considered notified when it receives written notification from the transferor or has knowledge that a transfer has occurred and that it had section 751 property. Regs. §1.6050K-1(e).

ii. If the partnership receives notification of a transfer after it has filed its partnership return in which the notice should have been reported, it must file Form 8308 with the Service Center or other Internal Revenue office with which it filed its partnership return within thirteen days of receiving notification of the transfer. Regs. §1.6050K-1(f)(2)

c. The partner's responsibility: The transferor of any partnership interest in a section 751(a) exchange must notify the partnership of the transfer in writing by the earlier of 30 days from the date of the transfer or January 15 of the calendar year following the calendar year in which the transfer occurred. The transferor must provide the following information:

i. The names and addresses of the transferor and transferee;

ii. The taxpayer identification numbers of the transferor and, if known, of the transferee; and

iii. The date of the transfer.

d. Notification not required: The partnership is not required to file Form 8308 if the transfer of its interests is not considered a section 751(a) exchange. Regs. §1.6050K(e)(2).
i. The partnership can rely on a written statement from the transferor as to whether or not the transfer was a section 751(a) exchange, absent knowledge to the contrary. Regs. §1.6050K(e)(2).

2. Section 1060 and certain basis adjustments: The residual method of determining goodwill or going concern value will be used in determining the allocation of basis adjustments made under sections 743(b) and 732(d) if the assets of the partnership constitute a trade or business for purposes of section 1060(c). Regs. §1.755-2T(a)(2).

a. Trade or business: A group of assets constitutes a trade or business if the use of the assets would constitute an active trade or business for purposes of section 355 or there is a chance that goodwill or going concern value could under any circumstances attach to the assets. The latter is based upon all the facts and circumstances surrounding the transaction.

b. Disclosure: The reporting requirements of §1060(b) are not applicable to transfers of partnership interests. Thus, the effect of section 1060 upon the transfer of partnership interests is to graft section 338 allocation rules onto section 755.

i. Statements are required to be attached to a partner's tax return showing the computation and allocation of the special basis adjustments under sections 743(b) and 732(d). Regs. §§1.743-1(b)(3) and 1.732-1(d)(3).