Partnerships and At Risk Problems

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*Mr. Tucker's discussion was based on notes rather than a formal paper and this excellent outline is included in lieu thereof. The omission of his outstanding discussion is regretted.*
I. THE DETERMINATION OF ADJUSTED BASIS

A. Basis: Impact of Means of Acquisition.

1. Property acquired by purchase—
   a. Generally, the basis is the cost of the property. Sec. 1012, I.R.C.

      (1) Recitals in a deed or contract are only evidence of cost; the actual cost will govern. Thus, if the cost is renegotiated at a later time, the renegotiated price applies. See also *Freedom Newspapers, Inc. v. Comm'r*, 36 TCM 1755 (1977), where a payment made by a third party to induce the taxpayer to purchase an asset was considered a reduction in basis of that asset, rather than income.

      (2) If the property is acquired in a taxable exchange, and the fair market value of the property acquired cannot be ascertained, the cost is deemed to be the fair market value of the property transferred by the purchaser. See, *e.g.*, *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954), and *Williams v. Comm'r*, 37 T.C. 1099 (1962).

   b. "Cost" includes:

      (1) Non-deductible acquisition expenses, such as title charges, brokers' commissions, appraisal fees, surveys, attorney's fees, and payments to remove clouds on title. See, generally, Tucker and Leahy, *The Deductibility of Costs Incurred by Real Estate Developers*, 1 J.R.E. Tax. 408 (1974).

      (2) Apportioned costs at settlement not deductible by purchaser, such as certain real estate taxes and non-deductible assessments.

      (3) Indebtedness assumed by the purchaser or incurred in the purchase of the property; but see *Redford v. Comm'r*, 28 T.C. 773 (1953), where the court held that basis did not include the face amount of a non-negotiable, non-interest bearing second mortgage note.

      (4) Indebtedness to which the purchaser takes the property subject. See *Crane v. Comm'r*, 331 U.S. 1 (1947); *Mayerson v. Comm'r*, 47 T.C. 340 (1966); and *Borinstein v. Comm'r*, 31 TCM 743 (1972); but see *Bixby v. Comm'r*, 58 T.C. 757 (1972).

   c. "Cost" does not include:

      (1) Deductible interest or deductible real estate taxes on acquisition.

      (2) Indebtedness assumed or taken subject to in the following circumstances:

         (a) If the property is subject to a mortgage in an amount greater than the value of the property at acquisition, cost may be limited to such value. See *Mayerson v. Comm'r*, 47 T.C. 340 (1966); *Borinstein v. Comm'r*, 31 TCM 743 (1972); *Hilton v. Comm'r*, 74 T.C. 305 (1980); *Beck v. Comm'r*, 74 T.C. . . . , No. 109 (1980); and *Narver v. Comm'r*, 75 T.C. . . . , No. 6 (1980). See also Rev. Rul. 69-77, 1969-1 C.B. 59, accepting the *Mayerson* decision, but reaffirm-
ing the intention of the Service to litigate the issue where appropriate. As to partnerships, see Sec. 752(c), I.R.C. See also Franklin's Estate v. Comm'r, 64 T.C. 752 (1975), aff'd 544 F.2d 1045 (9th Cir. 1976), finding that partnership obligations, incurred in a sale-leaseback transaction, were not sufficiently definite and unconditional to constitute cost basis for depreciation purposes; the Court noted that the "sale" was, in its view, really an option to acquire.


(i) See Pierce Estates, Inc. v. Comm'r, 195 F.2d 475 (3rd Cir. 1975), holding that a liability is contingent if its payment is dependent upon the occurrence of a subsequent, indeterminant event, such as the earning of profits.

(ii) In Rev. Rul. 80-235, 1980-35 I.R.B. 7, the Service found that a promissory note given by a partner to a partnership though recourse, did not create basis because it was payable only from, and to the extent of, partnership distributions.

(c) If the purported liabilities are in fact shams, then they will be utilizable as or includible in basis.

(i) See, generally, Goldstein v. Comm'r, 364 F.2d 734 (2d Cir. 1966), aff'd 44 T.C. 284 (1965), cert. denied 385 U.S. 1005 (1967); and Knetsch v. United States, 348 F.2d 932 (Ct. Cl. 1965). See also Rev. Rul. 80-236, 1980-35 I.R.B. 8, where the Service found no debt in a Subchapter S situation, and then pointed out that "the holdings do not preclude the imposition of penalties under any provision of the Code."

(ii) See Franklin's Estate v. Comm'r, 544 F.2d 1045 (9th Cir. 1976), aff'g 64 T.C. 752 (1975); and Miller v. Comm'r, 68 T.C. 767 (1977), involving the construction of a dormitory and adjacent dining hall for a college in a lease and lease-back situation, where, at the termination of the lease, the college owned the building without any additional payment.

(iii) See also Carnegie Productions, Inc. v. Comm'r 59 T.C. 642 (1973), and Rev. Rul. 77-125, 1977-1 C.B. 130, both dealing with motion picture transactions, where the maker of the note was found not to be liable thereon (and thus could not use the note as basis) because satisfaction of the note could come only from film earnings or from the guaranty of the owner of the film production rights. See, generally, Weidner, Realty Shelters: Non-Recourse Financing, Tax Reform, and Profit Purpose, 32 Southwestern L.J. 711 (1978).

(iv) See Rev. Rul. 78-411, 1978-2 C.B. 112, where purchases of animals for non-recourse notes were held to be loans by the investors, rather than bona fide purchases, in situations
where the seller agreed to buy any offspring at a specified price and guaranteed to repurchase the animals at a specified price after 5 years. See also *Villa v. Comm'r*, 40 TCM 938 (1980), holding that, under the relevant documentation, the taxpayer had made a loan, rather than an investment, so that no depreciation or investment tax credit could be claimed.

2. **Property acquired by gift**—
   
a. Generally, such property has the same basis as in the hands of the donor. Sec. 1015(a), I.R.C.

   b. There are three exceptions:
      
      (1) The basis is increased (but not above the fair market value at the time of the gift) by the amount of Federal gift tax actually paid, but, as to gifts made after December 31, 1976, only to the extent such gift tax is attributable to the appreciation in the property. Sec. 1015(d), I.R.C. See Reg. §1.1015-5(a)(2), Examples (1) and (2), and Reg. §1.1015-5(b).
      
      (2) If the property is later sold at a loss by the donee, the basis for computing loss is the lesser of (i) the basis in the hands of the donor, or (ii) the fair market value at the time of the gift. Sec. 1015(a), I.R.C.; Reg. §1.1015-1(a)(1). Thus, the donee does not recognize gain or loss in that situation where he sells the property at a price falling between the donor's basis and the fair market value at the date of the gift. See Reg. §1.1015-1(a)(2), Example.
      
      (3) If neither the donee nor the District Director is able to determine the basis in the hands of the donor, the basis is considered to be the fair market value of the property as of the date or the approximate date at which, according to the best information available, the property was acquired by the donor. Reg. §1.1015-1(a)(3).

3. **Property acquired by inheritance**—
   
a. As a result of the Crude Oil Windfall Profit Tax Act of 1980 (H.R. 3919, signed into law on April 2, 1980), the rule is that, generally, the basis of the property is its fair market value at the date of death or, if the alternate valuation date (up to six months after death) is used for Federal estate tax purposes, the value at such date used in the return becomes the basis. Sec. 1014(a), I.R.C.; Reg. §1.1014-1(a).
   
   b. As to property passing or acquired from a decedent dying after December 31, 1976 and before November 7, 1978, a special election may be made to enable the executor or administrator of the estate to use the carryover basis rules, under which the basis of property passing from a decedent is the same as the decedent's basis immediately before his death. Sec. 401(d) of the Crude Oil Windfall Profit Tax Act of 1980.

   c. Such carryover of basis is subject to certain upward adjustments (but not in excess of Federal estate tax values), including the increase in basis by Federal and/or local death taxes attributable to the appreciation element in the property. Secs. 1023(c), (e) and (f), I.R.C.

   d. As to the elective carryover basis, in order to minimize retroactivity, the adjusted basis of property of the decedent is increased, for
purposes of determining gain (but not for purposes of determining loss),
to its fair market value on December 31, 1976. Sec. 1023(h), I.R.C.

(1) As to marketable bonds or securities, the fair market
value on the date of determination was the closing average trading
price. Secs. 1023(h)(1) and (h)(2)(E)(i), I.R.C.

(2) As to all other property, the holding period is calcu-
lated, and the proportion thereof prior to the date of determination
is applied, on the same ratio, to the appreciation in value over basis.
Sec. 1023(h)(2), I.R.C.

4. Property acquired in exchange—
   a. If the exchange is tax-free, the basis of the property trans-
ferred becomes the basis of the property received, even though the
fair market value of one property exceeds the other. Sec. 1031(d),
I.R.C.

   b. If the transaction is only partially tax-free (that is, cash or
other property is received by the transferor), the basis of the property
received will be the basis of the property transferred, reduced by the
cash received (including mortgages assumed or taken subject to by
transferee) and increased by the amount of gain recognized and by
mortgages assumed or taken subject to by transferor. Secs 1031(b) and
1031(d), I.R.C.

5. Property received by individual from corporation—
   3. Generally, the basis of property received on liquidation of
the corporation is its fair market value at the time of liquidation (Sec.
334(a), I.R.C.); there is an exception for the one-month liquidation
under Sec. 333, I.R.C.

   b. Generally, the basis of property received as a dividend is its
fair market value on the date of distribution. Sec. 301(d), I.R.C.

   c. Generally, the basis of property received in redemption of
stock is its fair market value on the date of redemption. Sec. 301(d),
I.R.C.

6. Property acquired in satisfaction of a debt—
   a. Generally, property acquired (otherwise than through fore-
closure or purchase in lieu of foreclosure) in payment of a debt or satis-
faction of a claim has a basis equal to the fair market value of the
property on date of transfer. This is so even though the amount of the
debt or claim is greater or less than such fair market value. See, e.g.,
Swaim v. Comm'r, 417 F.2d 358 (6th Cir. 1969); and Vadner v.
Comm'r, 14 TCM 866 (1955).

   b. If the fair market value of the property is less than the
debt, the creditor is entitled to a bad debt deduction, if not previously
written off.

   c. If the property has no ascertainable fair market value when
the property is acquired, the creditor may utilize the amount of the debt
as basis. See, e.g., Society Brand Clothes, Inc. v. Comm'r, 18 T.C. 304
(1952); and Gould Securities Co. v. United States, 96 F.2d 780 (2d
Cir. 1938).
B. Adjusted Basis.

1. Generally, *adjusted basis* equals basis as determined above (Sec. 1016, I.R.C.), subject to the following principal adjustments:
   a. *Increased* for expenditures properly chargeable to capital account (that is, the cost of non-deductible property improvements, or carrying charges as to which the appropriate election, discussed below, is made). Sec. 1016(a)(1), I.R.C.; Reg. §1.1016-2.
   b. *Reduced* by receipts properly credited to capital account (see, e.g., *Inaja Land Co., Ltd. v. Comm'r*, 9 T.C. 727 (1947)), and by losses which directly affect capital account (such as loss due to fire or other casualty). Sec. 1016(a)(1), I.R.C.; Reg. §1.1016-5(a).
   c. Reduced by depreciation allowed or allowable. Sec. 1016(a)(2), I.R.C.; Reg. §1.1016-3. See also Reg. §1.167(a)-1; Reg. §1.167(a)-10(a); *Kansas City Southern Ry. Co. v. Comm'r*, 22 B.T.A. 949 (1931); and *Comm'r v. Superior Yarn Mills, Inc.*, 228 F.2d 736 (4th Cir. 1955).

2. Carrying charges may be capitalized and added to basis under the following circumstances:
   a. Under Sec. 266, I.R.C., an election may be made in connection with unimproved and unproductive real property, and real property being developed or improved (including already improved property being improved again), to capitalize and add to basis certain items otherwise deductible when paid or accrued.
   b. The election must be exercised by filing with the return a statement indicating the items so treated. (Reg. §1.266-1(c)(3).) Once made for a year, the election is binding for that year. See *Jackson v. Comm'r*, 172 F.2d 605 (7th Cir. 1949).
   c. The election is available as to the following items:
      (1) Real estate taxes;
      (2) Interest; however, this is the case only as to interest paid on a purchase money obligation or on money borrowed in connection with the property; interest paid on money borrowed for other purposes may not be capitalized (*Queensboro Corp. v. Comm'r*, 134 F.2d 942 (2d Cir. 1943));
      (3) Expenses of care and maintenance;
      (4) Fire protection (see *Warner Mountains Lumber Co. v. Comm'r*, 9 T.C. 1171 (1947)); and
      (5) If and only if the property is being developed or improved:
         (a) Social security and employment taxes paid to employees during the period of development;
         (b) Sales and use taxes paid on materials used in construction (Reg. §1.266-1(b)); and
         (c) Other “necessary expenditures” in connection with the property (Reg. §1.266-1(b)(ii)(d)).
   d. The election is made on an item-by-item basis; however, if several items of the same type are incurred with respect to a single
project, the election to capitalize, if made, must be exercised as to all items of that type. Reg. §1.266-1(b) and (c).

e. As to unimproved and unproductive property, the election as to each item (or class of items) may be exercised each year, regardless of how treated in any prior year. Reg. §1.266-1(c)(2)(i). On the other hand, where the property is in the process of development, the election as to each item (or class of items) is binding until completion of the particular project. Reg. §1.266-1(c)(2)(ii)(a).

f. The election as to unimproved land terminates when such unimproved land is put to productive use or when development is complete. Reg. §1.266-1(b).

3. See Sec. 189, I.R.C., as added by the TRA 1976, which adds to the basis of real property, on the sale or other disposition of such property, the unamortized portion of construction-period interest and real estate taxes. Note that, while Sec. 266 is elective, Sec. 189 is mandatory in its application.

II. THE OWNERSHIP OF PROPERTY: THE ALTERNATIVES

A. Individual Ownership vs. Corporate Ownership—General Considerations.

1. Advantages of Individual Ownership. Among the advantages—both tax and non-tax—of the individual ownership of property, as compared to corporate ownership, are the following:

a. Where the individual's income is relatively small, the individual's tax rates will be lower than corporate rates.

b. A single set of books, records and tax returns may be kept and filed by the individual; this is not, however, true of the partnership.

c. There is a single tax imposed on income from the property. Furthermore, depreciation and other "tax shelter" items may be utilized to offset other personal income, thereby reducing taxes.

d. Generally, sale procedures are simpler. If the corporation were to sell property, ordinarily the purchaser would require either a sale by the corporation (with potentially adverse tax consequences) or adequate warranties relating to the corporation and its status.

e. There are no corporate-type tax problems, such as personal holding company status, unreasonable accumulations of income, collapsibility and dividend distributions. (However, partnership ownership will, as noted below, entail some of such considerations.)

2. Disadvantages of Individual Ownership. Among the disadvantages—both tax and non-tax—of the individual ownership of property are the following:

a. Where the individual's income is high, and does not constitute "personal service income" (see Secs. 911(b) and 1348, I.R.C.), the individual's tax rates will be significantly greater than the corporate tax rates.

b. The "dealer" will encounter difficulties in segregating in-
vestment holdings from property held for sale. See, e.g., *Tibbals v. United States*, 362 F.2d 266 (Ct. Cl. 1966); and *Black v. Comm'r*, 45 B.T.A. 204 (1941); but see *Cary v. Comm'r*, 32 TCM 913 (1973); *Adam v. Comm'r*, 60 T.C. 996 (1973); and *Ridgewood Land Co. Inc. v. Comm'r*, 31 TCM 39 (1972), aff'd 477 F.2d 135 (5th Cir. 1973).

c. Where the individual owns property, personal liability on the mortgage, in the absence of explicit exculpatory clauses in mortgages or the very problematical use of straw or nominee corporations, is likely to present a significant danger.

3. **Considering the Future.** In deciding upon the form of property ownership, the taxpayer must consider the impact of the initial ownership upon future planning. For example, assuming that the property being considered is real estate, it must be noted that:
   a. Where the corporation initially takes title to the real estate, and the stockholder later decides that he would like to own the real estate personally, (i) liquidation may entail collapsible corporation problems (Sec. 341, I.R.C.), gain to the extent of any increase in value (Sec. 331, I.R.C.; but see Sec. 333, I.R.C.), which gain may be partially or wholly taxable as ordinary income (Secs. 1245 and 1250, I.R.C.), or double taxation upon sale (but see Sec. 337, I.R.C.); (ii) use of the property in redemption may entail, in addition to the foregoing considerations, the possibility of a tax imposed upon the corporation where the redemption is made with appreciated property (Sec. 311(d), I.R.C.), as well as ordinary income to the stockholder (Sec. 302, I.R.C.); and (iii) distribution of the property to the stockholder other than in liquidation or redemption may result in a taxable dividend (Sec. 301, I.R.C.).
   b. Where property is transferred from one form of ownership to another, and depreciation commenced under the first form of ownership, the second form of ownership becomes a "second user" entitled only to a lesser rate of depreciation, even though both forms of ownership involve the same persons in the same percentages of ownership. See Reg. § 1.167(c)-1(a)(6).
   c. Where property is owned by an individual or partnership, and it is desired to place the same into a corporation in order to enter a tax-free reorganization with another corporation or a real estate investment trust, this cannot be done as a step in a pre-arranged plan of reorganization, or taxability will result from the transfer to the corporation. Rev. Rul. 70-140, 1970-1 C.B. 73; see also *Rodman v. Comm'r*, 57 T.C. 113 (1971), where the application of Rev. Rul. 70-140 was stipulated. However, where there is no pre-arranged plan, or prior commitment, to enter into the subsequent step, taxability will not result from the first transfer. See, e.g., *Vest v. Comm'r*, 57 T.C. 128 (1971), mod. other grounds 481 F.2d 238 (5th Cir. 1973).

**B. Tenants in Common.**

1. Generally, tenants in common own undivided fractional interests in property. Thus, a tenant in common may freely dispose of his interest
in the property, and the transferee becomes a co-tenant with the other tenants in common.

2. Each tenant in common is required to report his share of income or losses produced by the property. On the theory that a tenant in common is liable personally only for his share of expenses, a tenant in common may deduct only that portion of the expenses attributable to his interest in the property, even though he may pay all of the expenses related to the property. See Boyd’s Estate v. Comm’r, 28 T.C. 564 (1957), and Webb’s Estate v. Comm’r, 30 T.C. 1202 (1958). Gain or loss realized on the sale or other disposition of the property is divided among the tenants in common in proportion to their respective interests. See, generally, Fowler, Tax Aspects of Gifting Fractional Interests in Realty, 7 J.R.E. Tax. 5 (1980).

3. If there is activity involved, the Service may claim that in actuality a partnership exists. See Reg. §301.7701-3(a); Powell v. Comm’r, 26 TCM 161 (1967); and Ostrow v. Comm’r, 15 TCM 957 (1956); but see Rev. Rul. 75-374, 1975-2 C.B. 261, dealing with a real estate investment trust. Note that in Levine’s Estate v. Comm’r, 72 T.C. 780 (1979), where the taxpayer held properties as a tenant in common with another person, the Court accepted the contention of the Service that, because such tenants in common “engaged in an active business, performed various services, and shared the gains and losses”, they were “engaged in the operation of a partnership”. [Among other things, this may require any reinvestment of condemnation proceeds to be made at the entity level (see Demirjian v. Comm’r, 457 F.2d 1 (3rd Cir. 1972)), and may prevent different individuals from using different rates of depreciation for their respective interests in the property.]

C. Joint Tenants With Rights of Survivorship.

1. Generally, each joint tenant is a co-owner of property having an individual interest therein under a single deed; when one dies, his title passes immediately to the other joint tenants. However, a joint tenant may, in many jurisdictions, freely dispose of his interest, thereby breaking the joint tenancy, in which case the conveyee becomes a tenant in common with the other tenants. In most jurisdictions, a joint tenant does not have partition rights, but a tenant in common has such rights. [Note, however, that a tenant in common may generally effectively waive his partition rights. See, e.g., Coleman v. Coleman, 19 Pa. 100 (1852); and Prude v. Lewis, 78 N.M. 256, 430 P.2d 753 (1967); but see Condrey v. Condrey, 92 So.2d 423 (Fla. 1957).]

2. Each joint tenant is required to report his share of any income or losses produced by the property. See Haynes v. Comm’r, 7 B.T.A. 465 (1927). However, the expenses incurred on or with respect to the property are deductible only by the joint tenant who pays them, on the theory that the joint tenant incurs joint liability for all expenses with respect to the property. See Tracy v. Comm’r, 25 B.T.A. 1055 (1932),

D. Tenants by the Entirety.

1. In most jurisdictions, this applies only in the case of a husband and wife.
2. It is similar to the joint tenancy in that the surviving spouse acquires title from the deceased spouse, and the ownership is co-equal. The tax impact is the same as that on the joint tenancy. See Rev. Rul. 71-268, 1971-1 C.B. 58.

E. General Partnerships.

1. The partnership is not a taxable entity for Federal income tax purposes, although it is a reporting entity. Sec. 701, I.R.C.
   a. The exchange of partnership interests may, accordingly, qualify as a like-kind exchange under Sec. 1031, depending on the underlying property. See Meyer's Estate v. Comm'r, 58 T.C. 311 (1972), aff'd 503 F.2d 556 (9th Cir. 1974). (Note, however, that the Service has non-acquiesced in this decision, in 1975-1 C.B. 3. See also Rev. Rul. 78-135, 1978-1 C.B. 256.) In addition, see Gulfstream Land and Development Corp. v. Comm'r, 71 T.C. 517 (1979), where the Court found that an exchange of partnership interests could qualify as a like-kind exchange if the underlying properties would so qualify. See, generally, Banoff and Fried, An Analysis of Recent IRS Attempts to Narrow the Scope of the Tax-Free Like-Kind Exchange, 51 J. Tax. 66 (1979); and Halpern, Partnership Swapping—"From Miller to Meyer to Gulfstream": A Saturday Movie Serial, 6 J.R.E. Tax. 359 (1979).
   b. Caveat—certain elections, such as those under Sec. 754, 1033 and 1039, I.R.C., must be made at the partnership level, rather than by the individual partners. See, e.g., Demirjian v. Comm'r, 457 F.2d 1 (3rd Cir. 1972).
2. The term "partnership" is defined to include a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a corporation or trust or estate within the meaning of the Code. Sec. 761(a), I.R.C., and Reg. §1.761-1(a)(1). See also McDougal v. Comm'r, 62 T.C. 720 (1974).
   a. A joint undertaking merely to share expenses is not considered a partnership. See, e.g., Reg. §1.761-1(a)(1), example of joint ditch to drain water.
   b. The mere co-ownership of property maintained, kept in repair, and rented or leased does not constitute a partnership (see Reg. §1.761-1(a)(1), example of farm leased to farmer for share of crops or cash rental); however, in contrast, tenants in common may be considered partners if they actively carry on a trade, business, financial operation or venture and divide the profits therefrom. See Reg. §301.7701-3(a). But see Rev. Rul. 75-364, 1975-2 C.B. 261, holding
a life insurance company and a REIT to be tenants in common in the
ownership of an apartment building, which is managed by an unrelated
management company, which furnishes (and receives the profits from)
all services other than customary services.

c. All members of an unincorporated organization availed of
for (i) investment purposes only and not the active conduct of a business
or (ii) the joint production, extraction or use of property, but not the
selling of services or the property produced or extracted, may elect
to exclude the organization from the partnership provisions of the Code,
if the income of such persons may be adequately determined without the
computation of partnership taxable income. Sec. 761(a), I.R.C.

d. There is generally no requirement that there be a written
partnership agreement. See, e.g., Buckley v. United States, 76-1 USTC ¶9473 (W.D. Tex. 1976).

3. The “joint venture” is, under most state laws, merely a general
partnership.

a. The traditional difference between the “joint venture” and
the general partnership is that the “joint venture” is usually formed to
hold one piece of real estate or one project, while the general partnership
is ordinarily operational and used in the mercantile or similar areas.
1971); 2 Rowley, Law of Partnership §52.1 et. seq.; and Nichols,

b. Although there are some technical differences under state
law between the “joint venture” and the general partnership, perhaps the
only significant difference is that the corporate laws of some states
prohibit a corporation from becoming a “partner” but not from be-
coming a “venturer”.

F. Limited Partnerships.

1. Non-Tax Advantages. Among the non-tax advantages of the
limited partnership as the owning entity are the following:

a. Because it is required to file with the appropriate recording
authorities a certificate of limited partnership (ULPA, Sec. 2), the
limited partnership, for which any one or more of the general partners
may be authorized to sign documents, may itself take legal title to
partnership property.

b. An interest in the partnership is considered personal property,
so that the transfer of an interest is the transfer of personal property.
(ULPA, Sec. 18) The sale of the project may be effectuated by selling
the partnership interests, thereby avoiding payment of state or local real
property transfer taxes; caveat—certain jurisdictions are understood to
be questioning this means of circumventing transfer taxes.

c. Lack of forms and formalities required to conform with
ULPA, as compared with the bookkeeping, formalities and state and
Federal filings required for the corporation.

2. Non-Tax Disadvantages. Among the non-tax disadvantages of the
limited partnership as the owning entity are:
a. Generally, the general partners of the limited partnership [and the limited partners if they are not cautious in exercising management or control functions—see ULPA, Sec. 7 (but contrast California Limited Partnership Act §15507, imparting protection to investors if certain "investor democracy" rights under CLPA §15520 are exercised); and see Feld, The "Control" Test for Limited Partnerships, 82 Harv. L. Rev. 1471 (1969), and Note, Partnership: Can Rights Required to Be Given Limited Partners Under New Tax Shelter Investment Regulations Be Reconciled with Section 7 of the Uniform Limited Partnership Act? 26 Okla. L. Rev. 289 (1973)] have personal liability for all partnership debts and obligations. (ULPA, Sec. 9.)

b. State usury laws (which usually do not limit the rates of interest on corporate loans because corporations generally cannot plead the defense of usury) may create problems for the partnership.

3. Tax Advantages. Generally, but subject to further, more detailed discussion below, among the tax advantages of the limited partnership (as well as the general partnership) as the owning entity are:

a. Because the limited partnership is not considered a taxable entity, there is no double taxation imposed upon the partnership and its partners. Sec. 701, I.R.C.; Reg. §1.701-1. Rather, losses pass through the limited partnership to its partners and may be utilized to offset income from other sources; and partnership income is taxed at only one level—that of the partners. Secs. 701 and 702, I.R.C.

b. As compared with the complexities of Section 341 (applying to collapsible corporations), the rules of Section 751 (applying to "collapsible partnerships") are relatively limited in scope. But see Anderson and Bloom, Collapsible Partnerships: The Complexities of Section 751, 2 J.R.E. Tax. 425 (1975); and Applebaum, Collapsible-Partnership Danger Increases with Use of Partnerships as Tax Shelters, 42 J. Tax. 272 (1975). [Caveat: The term "unrealized receivables", as used in Sec. 751(c), will include Sec. 1245 and Sec. 1250 property, as well as farm recapture property (under Sec. 1251) and farm land (under Sec. 1252) to the extent of the amount that would have been treated as gain to which the relevant provision would have applied if such property had been sold by the partnership at its fair market value at the time.]

c. Distributions by the partnership to a partner will generally not, in and of themselves, cause recognition of gain or loss, so long as the partner retains a tax basis for his partnership interest. Sec. 731, I.R.C.; but see Secs. 736, 741 and 751, I.R.C. See, generally, Parker and Lee, Constructive Cash Distributions in a Partnership: How and When They Occur, 41 J. Tax. 88 (1974).

d. There is a freedom of operation, both as to requisite income sources, and the lack of limitation upon the number of owners and the values of their respective holdings in a limited partnership, compared with the stringent rules as to the same governing the real estate investment trust.

e. There is an absence of personal holding company or unreasonable accumulation of income problems.
4. The Partnership as an "Association".

a. Generally—

(1) An entity will be deemed an "association taxable as a corporation", irrespective of its form or applicable state law, if it has more corporate characteristics than non-corporate characteristics. Reg. §301.7701-2(a)(3).

(2) In considering whether an entity constitutes a limited partnership or such an association for Federal income tax purposes, there are six corporate characteristics: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property and (6) free transferability of interests. Reg. §301.7701-2(a)(1). See, generally, Katz, Service Agrees to Follow the Tests of Partnership Recognition as Stated in Larson, 51 J. Tax. 12 (1979).

(3) The first two characteristics are generally considered always to be present in a business organization of at least two people; however, the possibility that the general partner does not have the requisite objective to carry on business for profit was at least one of the reasons behind Rev. Proc. 74-17, 1974-1 C.B. 438. But, the Regulations base the determination of whether an entity will be treated as an association on the presence or absence of the remaining four factors. If a majority of such characteristics are present in a particular situation, the entity will be considered an association taxable as a corporation. In the event that two of such characteristics are present and two are absent in the given situation, other factors may be examined in a classification of the entity. See Outlaw v. United States, 494 F.2d 1376 (Ct. Cl. 1974). But contrast Larson v. Comm'r, 66 T.C. 159 (1976). See Rev. Rul. 79-106, 1979-1 C.B. 448, holding that certain factors will not, by reason of Larson, be considered as "other factors" in determining the classification of an entity. These are:

   (a) The division of limited partnership interests into units or shares and the promotion and marketing of such interests in a manner similar to corporate securities;

   (b) The managing partner's right or lack of the discretionary right to retain or distribute profits according to the needs of the business;

   (c) The limited partners' right or lack of the right to vote on the removal and election of general partners and the right or lack of the right to vote on the sale of all, or substantially all, of the assets of the partnership;

   (d) The limited partnership interests being represented or not being represented by certificates;

   (e) The limited partnership's observance or lack of observance of corporate formalities and procedures;

   (f) The limited partners being required or not being required to sign the partnership agreement; and

   (g) The limited partnership providing a means of
pooling investments while limiting the liability of some of the participants.

b. See Larson v. Comm'r, 66 T.C. 159 (1976), and Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975), both of which held that the entities involved were, under the "association" Regulations (that is, §301.7701-2), partnerships, not associations taxable as corporations. As a reaction to these cases Proposed Regulations (intended to replace the existing "association" Regulations) were promulgated by the Internal Revenue Service on January 5, 1977, but were subsequently permanently withdrawn by then Secretary of the Treasury Simon on January 14, 1977.

5. Basis for the Partnership Interest—

Generally.

a. The contrast of the Subchapter S corporation—

(1) The tax basis of the stockholder in a Subchapter S corporation is limited to the sum of (i) the cost or other adjusted basis of his stock and (ii) the adjusted basis of any debt of the corporation directly to him. Sec. 1374(c)(2), I.R.C.; Reg. §1.1374-1(b)(4).


(3) The technique of switching corporate loans guaranteed by stockholders to stockholder loans at the very end of the corporation's fiscal year, in order to create basis for the stockholder, was held to be ineffective in Underwood v. Comm'r, 63 T.C. 468 (1975), aff'd 535 F.2d 309 (5th Cir. 1976). The Tax Court refused to elevate form over substance in order to create such basis, where "the only effect of these new notes was to shift the liabilities for the prior loans." But see Rev. Rul. 75-144, 1975-1 C.B. 277.

b. The partnership—

(1) Under Sec. 722, I.R.C., a partner's basis in the partnership, for purposes of determining loss deductions, is equal to the adjusted basis of any property contributed by him to the partnership.

(2) Under Sec. 752(a), I.R.C., any increase in a partner's share of partnership liabilities, or any increase in his personal liabilities by reason of his assumption of any partnership liabilities, is considered as a contribution of money by such partner to the partnership, thereby increasing his basis.

(3) Under Sec. 752(c), I.R.C., any liability to which the property is subject is, to the extent of the fair market value of the property, considered a liability of the property owner, thereby increasing his basis under and pursuant to Sec. 752(a). See, in this context, Crane v. Comm'r, 331 U.S. 1 (1947), in the non-partnership situation. See, generally, Epstein, The Application of the Crane Doctrine to Limited Partnerships, 45 S.Cal. L. Rev 100 (1972); and Halpern, Footnote 37

(4) Notwithstanding Crane v. Comm'r, 331 U.S. 1 (1947), and Sec. 752(c), I.R.C., but subject to the discussion below as to Sec. 465, I.R.C., the limited partner in a limited partnership might be questioned, as the Service has from time to time sought to do, as to his basis, if any, in non-recourse loans of the partnership.

(a) Although apparently not currently a problem, the two-tiered partnership situation has in the past been one area in which the Service has raised threats. The Service argument was apparently focused on the definition of a "partner" under Sec. 761(b), I.R.C. The Service questioned, erroneously, whether a partnership could itself be a member of a partnership.

(b) Another issue of current interest is whether a person who acquires a partnership interest, but is not admitted to the partnership as a substituted limited partner, is entitled to his pro rata share of partnership losses. In Evans v. Comm'r, 54 T.C. 40 (1970), affirmed 447 F.2d 547 (7th Cir. 1971), the taxpayer assigned his partnership interest to his wholly-owned corporation without his partner's knowledge or approval. The Service, relying on Burnet v. Leininger, 285 U.S. 136 (1932), contended that the assignment was ineffective. However, the Tax Court, referring to United States v. Atkins, 191 F.2d 146 (5th Cir. 1951), found that the assignment was effective, so that the corporation owned a capital interest in the partnership, as required under Sec. 704(e), I.R.C., because capital was a material income-producing factor in the business. In Rev. Rul. 77-137, 1977-1 C.B. 178, the Service effectively followed Evans, by ruling that where an assignee acquired all of the dominion and control over a partnership interest, and where the partnership agreement provided the assignee would share in partnership profits and losses even without the requisite consent of the general partners where substitution of the assignee as a partner was not granted, then the assignee would be treated as a partner for Federal income tax purposes. See, however, Reg. §301.7701-2(e)(2), recognizing, in connection with the association test of free transferability of interest, the right to transfer a profits interest only, without the transfer of the right to participate in partnership management.

(5) As provided in Reg. §1.752-1(e), "where none of the partners have any personal liability with respect to a partnership liability (as in the case of 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), then all partners, including limited partners, shall be considered as sharing such liability...in the same proportion as they share the profits." Thus, subject to the discussion below as to Sec. 465, I.R.C., the limited partner clearly includes in his basis for his limited partnership interest any non-recourse liabilities, to an extent proportionate to that in which he shares partnership profits. See, gen-

(6) If the general partner is personally liable on a partnership liability, the general partner, but not any limited partner, will include such liability in the basis for his partnership interest. (Reg. §1.752-1(a)(2).) Furthermore, if the partnership assumes a liability so that the general partner becomes personally liable, only the general partner's basis for his interest in the partnership would be increased by the amount of such liability. (Reg. §1.752-1(e) (Example).) Where it is not the general partner, but his wholly-owned (or even 80%-controlled) corporation, which has guaranteed the loan, will that be considered as a liability of the general partner? Reg. §1.752-1(e) refers to "none of the partners [having] any personal liability with respect to a partnership liability". No attribution reference is made; the words "directly or indirectly" are not used. *Cf.*, *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975), where the Court of Claims found that there could not be any constructive ownership rule applied (in considering centralization of management) in the absence of statutory or Regulation reference to the same. Yet, *caveat emptor*—particularly in light of the reference in Rev. Proc. 75-16, 1975-1 C.B. 676, to any other benefits to creditors, such as recourse rights against other property.

(7) Where the general partner has guaranteed only the top portion of the permanent loan, and the "floor-loan" portion (or that portion which the lender agrees to fund without conditions, such as meeting a rent roll or occupancy requirements) carries no such guarantee, the floor-loan portion should provide basis to all partners in the limited partnership. However, an abundance of caution would call for two separate notes, even though they might have to be secured by the same mortgage, with cross-default provisions if required by the lender.

(8) An agreement between the general partner and the limited partners whereby the limited partners agree to indemnify and hold harmless the general partner for any payments exceeding his *pro rata* share of the liabilities of the partnership would not afford additional basis to the limited partners to the extent of their *pro rata* share of such liabilities, for their agreement is with the general partner individually and creates no obligation to the partnership. *Rev. Rul. 69-223*, 1969-1 C.B. 184.

(9) *See Rev. Rul. 72-135*, 1972-1 C.B. 200, were the Service held that a loan from the general partner to a limited partner, or from the general partner to the limited partnership, purportedly made on a non-recourse basis, would be treated as a contribution to the capital of the partnership by the general partner, rather than as a loan, thereby precluding an increase in the bases of the interests of the limited partners with respect to any portion of such loans. *See also Rev. Rul. 72-350*, 1972-2 C.B. 394, where the Service ruled that a non-recourse loan by a third party to the limited partnership, which was
secured by a highly speculative and relatively low value property of the partnership, and which was convertible into a partnership interest, was not a *bona fide* loan, but rather an equity contribution to the partnership.


a. The "at-risk" limitation, as applicable prior to 1979—


(2) Under Sec. 704(d), I.R.C., non-recourse partnership liabilities remained as basis for purposes of computing gain or loss on sale or other disposition of the property. However, such non-recourse liabilities *did not* provide basis for taking losses; this basis was limited to the amount the partner had "at risk".

(3) While Sec. 704(d) was based on Sec. 465, I.R.C. (also added by the TRA 1976), it differed in two very material respects, as follows:

   (a) Sec. 704(d) applied to any partner, whether general or limited, who had no personal liability. (Although Sec. 465 was not applicable to regular corporations, Sec. 704(d) covered all partners, even regular corporations.)

   (b) Sec. 465 applied to certain specified activities, whereas Sec. 704(d) excluded those activities (but not partnerships engaging in those activities, where such partnerships also engaged in activities not covered by Sec. 465) and Sec. 704(d) did not apply to any partnership the principal activity of which was "investing in" real property (other than mineral property).

   (i) The General Explanation of the TRA 1976 prepared by the Staff of the Joint Committee on Taxation, and dated December 29, 1976, notes (at page 97, footnote 7), that: "Generally, the principal activities of a partnership would involve real property if substantially all of its activities involve the holding of real property for sale, for investment, or for deriving rental-type income.”

   (ii) While the two-tier partnership situation was apparently intended to be covered by footnote 7 on page 97 of the General Explanation, the language is not free from ambiguity. Such language is: "The holding of real property for sale, for investment, or for deriving rental-type income would include the investment in a partnership or joint venture where substantially all of the activities of the partnership or joint venture involve the holding of real property for sale, for investment, or for deriving rental-type income.”

b. The 1978 Act revised the at risk rules in several respects, generally as follows:

(1) The 1978 Act expanded the specific at risk rule of Sec. 465, I.R.C., to cover all activities other than real estate, effective for
taxable years beginning after December 31, 1978. Sec. 465(c)(3), I.R.C.

(a) Activities engaged in by the taxpayer in carrying on a trade or business or for the production of income are now covered. Sec. 465(c)(3)(A)(i), I.R.C.

(b) Activities which constitute a trade or business will be treated as one activity, and thus aggregated, if the taxpayer actively participates in the management of such trade or business, or if such trade or business is carried on by a partnership or Subchapter S corporation and 65% or more of the losses for the taxable year are allocable to persons who actively participate in the management. Sec. 465(c)(3)(B), I.R.C.

(c) On the other hand, the Service is given broad discretion to aggregate, or to treat as separate, any activities newly covered. Sec. 465(c)(3)(C), I.R.C. See, generally, Klein, Coping with the At-Risk Rules: Planning Opportunities Suggested by the 1978 Act, 51 J. Tax. 22 (1979).

(2) As noted, the holding of real property (other than mineral property) will be treated as a separate activity, so that the at risk rules will not apply to losses from that activity. Sec. 465(c)(3)(D), I.R.C.

(a) Special allocation rules are to be applied for determining income, deductions and basis where activities of a trade or business or the production of income include the holding of real property (other than mineral property).

(b) Real estate used in any one of the four activities specified in Sec. 465(c)(1), I.R.C., continues to be treated as part of that activity, rather than as a separate activity. See General Explanation of the TRA 1976, prepared by the Staff of the Joint Committee on Taxation, at pages 35-39.

(c) Personal property and services which are incidental to making real property available as living accommodations are treated as part of the activity of holding such real property.

(d) Is a second-tier partnership holding an interest in a first-tier partnership which owns and operates real property, such as a low-income housing project, “holding real property”? In the General Explanation of the 1978 Act, footnote 2, on page 132, states: “If a partnership (‘investing partnership’) is a partner in another partnership (‘primary partnership’) and the primary partnership is engaged in a real estate activity which is not subject to the at risk rules, the partners of the investing partnership would not be subject to the at risk rule with respect to its activity of investing in the primary partnership to the extent that such investment is attributable to the real estate activity.”

(3) Because all taxpayers, other than certain regular corporations, are now covered by Sec. 465, the 1978 Act repealed the at risk rule of Sec. 704(d), I.R.C., effective for taxable years beginning after December 31, 1978.
(4) Under Sec. 465(a)(1)(C), I.R.C., the at risk rules now apply to corporations in which 5 or fewer individuals directly or indirectly own more than 50% of the stock, other than certain corporations actively engaged in equipment leasing. See Sec. 465(c)(3)(D)(ii), I.R.C.

(a) A corporation is not considered to be actively engaged in "equipment leasing" unless 50% or more of the gross receipts of the corporation for the taxable year are attributable to leasing and selling Section 1245 property. Sec. 465(c)(3)(D)(ii)(II), I.R.C.

(b) The term "Section 1245 property" does not, for these purposes, include master sound recordings, and other similar contractual arrangements with respect to tangible or intangible assets associated with literary, artistic or musical properties. See 465(c)(3)(D)(ii)(III), I.R.C.

(5) Sec. 465(e), I.R.C., requires the recapture of previously allowed losses (that is, losses which were allowed and reduced the taxpayer's at risk basis in the activity involved for taxable years beginning after December 31, 1978) where the amount at risk is reduced below zero.

(6) Generally, the new at risk rules apply to taxable years beginning after December 31, 1978. See Section 204(a) of the 1978 Act. However, there are three key transitional rules, as follows:

(a) Under Section 201(b)(2) of the 1978 Act, it is provided that, to the extent losses have been disallowed for a taxable year under Sec. 704(d), I.R.C., such losses will be treated as if they had been disallowed under Sec. 465, I.R.C., and thus be allowed for the first taxable year after December 31, 1978 in which the taxpayer has acquired basis therefor.

(b) The at risk rules of Sec. 465, I.R.C., will not at any time apply to partnership liabilities not subject to the at risk rules of Sec. 704(d), I.R.C., because incurred prior to January 1, 1977. See Section 204(b)(2) of the 1978 Act.

(c) If the amount for which the taxpayer is at risk in any activity as of the close of the taxpayer's last taxable year beginning before January 1, 1979 is less than zero, then new Sec. 465(e)(1), I.R.C., is applied with respect to such activity of the taxpayer by using such negative amount rather than zero. Section 204(b)(1) of the 1978 Act.


[For purposes of the remainder of this outline, particular emphasis is placed on the General Explanation of the Revenue Act of 1978, prepared by the Staff of the Joint Committee on Taxation on March 12, 1979 (hereinafter referred to as the "General Explanation") and the Proposed Regulations under Sec. 465, I.R.C., published in the Federal Register on June 5, 1979 (hereinafter referred to as the "Prop. Regs."). In addition, it is believed that the problems for partnerships and]
partners will be better seen and understood through the asking of a series of questions, as set forth below.

a. When is the amount at risk determined?
   (1) Under Prop. Reg. §1.465-1(a), the determination of the amount the taxpayer is at risk "in cases where the activity is engaged in by an entity separate from the taxpayers is made at the close of the taxable year of the entity engaging in the activity (for example, a partnership)."

   (2) Moreover, where the activity is engaged in by an entity separate from the taxpayer, references to a taxable year apply to the taxable year of the entity (unless otherwise stated). Prop. Reg. §1.465-1(a).

b. How does a taxpayer obtain deductions from an activity to which Sec. 465 applies?
   (1) Deductions which are allocable to an activity and otherwise allowable will be allowable in a taxable year to the extent of the income received or accrued from that activity in such taxable year, whether or not there is any amount at risk. Prop. Regs. §§1.465-2(a) and -11(c)(2) (Example).

   (2) Deductions in excess of the income received or accrued from the activity for a taxable year will be allowable to the extent the taxpayer is at risk with respect to the activity at the close of the taxable year. Prop. Regs. §§1.465-2(a) and -11(a)(2) (Example).

c. What happens with a disallowed loss?
   (1) A disallowed loss is carried over to the next taxable year. Prop. Reg. §1.465-2(b).

   (2) There is no limit to the number of years to which a taxpayer may carry over a loss disallowed solely by reason of Sec. 465(a). Prop. Reg. §1.465-2(b).

d. What is a "loss" for purposes of Sec. 465(d), I.R.C.?
   (1) A loss is (i) the excess of allowable deductions allocable to an activity over (ii) the income received or accrued from the activity by the taxpayer for the taxable year. Prop. Reg. §1.465-11(a)(1). Such loss is determined without regard to the amount at risk. Prop. Reg. §1.465-11(c).

   (2) The concept of "income" includes gain recognized upon the disposition of the activity or an interest in the activity, including, as an illustration, gain on liquidation by a partnership of a partner's interest in the partnership. Prop. Regs. §§1.465-12(a) and -66(a).

      (a) The character of the gain is irrelevant, so that short-term capital gains and long-term capital gains attributable to the activity are considered "income" from the activity. Prop. Reg. §1.465-12(a).

      (b) In the case of exploring for, or exploiting, oil and gas resources (one of the four specified activities under the Tax Reform Act of 1976), "income" includes "all receipts related to exploring for, or exploiting, oil and gas resources and which constitute gross income from the property within the meaning of section 613".
(3) Allowable "deductions" allocable to an activity are those otherwise allowable deductions incurred in a trade or business or for the production of income from the activity. Prop. Reg. §1.465-13(a).

(a) A capital loss is treated as a deduction without regard to Sec. 1211, I.R.C. Prop. Reg. §1.465-13(a).

(b) The capital gain deduction under Sec. 1202, I.R.C. is not treated as a deduction allocable to an activity. Prop. Reg. §1.465-13(b)(1).

(c) Prop. Reg. §1.465-38(a) contains an ordering system for allowing items of deductions under Sec. 465, which provides that capital losses are first, Sec. 1231 losses are second, non-tax preference items are third, and tax preference items are last.

(d) Disallowed deductions are to be subdivided according to the taxable year in which originally paid or accrued, with those of the earliest taxable years used first. Prop. Reg. §1.465-38(c).

(e) Does Sec. 465 apply other than with regard to the allowance of losses in connection with covered activities?

(1) According to Prop. Reg. § 1.465-1(e), Sec. 465 does not apply other than to limit the allowance of losses in connection with covered activities.

(2) Prop. Reg. §1.465-1(e) provides that "the adjusted basis of a partner in a partnership interest is not affected by section 465." What does this mean? Is it favorable or unfavorable?

(a) By reason of this provision, non-recourse liabilities (not at risk) still constitute basis for purposes of sale or other disposition or the investment tax credit. See General Explanation of the Tax Reform Act of 1976, prepared by the Staff of the Joint Committee on Taxation on December 29, 1976, at page 36. See also Page and Mitchell, Expanded "At Risk" Rules of 1978 Act Will Further Restrict Shelters and Add Confusion, 50 J. Tax. 146 (1979).

(b) On the other hand, it means that the basis reduction provided in Sec. 1016(a)(2), I.R.C. as to depreciation allowed or allowable under Sec. 167, I.R.C. occurs whether or not Sec. 465 has served to prevent use of the otherwise-allowable deduction. Supposedly, this is compensated for by the fact that, on sale or other disposition, the partner is treated as being at risk with respect to any gain from the disposition, and so is able to deduct any suspended losses at that time. See General Explanation of the Tax Reform Act of 1976, at page 36, footnote 4.

(f) Does a partner receive at risk basis for amounts loaned by such partner to the partnership?

(1) Prop. Reg. §1.465-7(a) states that the "amount at risk in an activity of a partner who lends the partnership money for use in the activity shall be increased by the amount by which the partner's basis in the partnership is increased under §1.752-1(e) due to the incurrence by the partnership of that liability."

(2) Reg. §1.752-1(e) does not directly provide basis to a
partner for a loan to the partnership. Moreover, is the amount loaned a recourse or non-recourse loan? If recourse, is the sole recourse to the lending partner, so that only he receives basis for the loan, or is the recourse also to other partners, such as all general partners (whether the partnership is a general partnership or a limited partnership)?

(3) The non-lending partners do not receive basis for such loan by a partner. Prop. Reg. §1.465-7(a). This is consistent with Rev. Rul. 72-135, 1972-1 C.B. 200, but is not wholly consistent with the General Explanation, which would differentiate the four activities specified in the Tax Reform Act of 1976 and activities involving "tax shelter characteristics" from other activities. See General Explanation, page 133.

g. When are amounts contributed to the partnership considered as being at risk?

(1) Where a taxpayer borrows money for use in the activity, but the taxpayer is not personally liable for repayment of the loan, then the taxpayer will be at risk only if the taxpayer pledges as security property not used in the activity. Prop. Reg. §1.465-25(a)(1).

(a) The at risk amount will not exceed the net fair market value of the pledged property. Prop. Reg. §1.465-25(a)(1).

(i) There is no definition of fair market value in reaching net fair market value. See, however, Gift Tax Reg. §25.2512-1.

(ii) Net fair market value is the excess of fair market value at the date of the pledge over the total amount of superior liens to which the property is subject. Prop. Reg. §1.465-25(a)(4).

(A) Subsequent increases or decreases in superior liens will require adjustments in the net fair market value.

(B) However, subsequent increases or decreases in fair market value will not result in adjustments in the net fair market value. This seems particularly unfair, especially in light of the impact of inflation on fair market values.

(C) Moreover, the fact that a superior lien also encumbers other property, the value of which may far exceed the lien, has no impact on the net fair market value calculation.

(b) The pledge as security of property used in the activity will not increase the taxpayer's basis. Prop. Reg. §1.465-25(b)(1)(i).

(i) Use of the partnership interest as security does not increase the partner's at risk basis for amounts borrowed for use in the partnership. Prop. Reg. §1.465-25(b)(1)(i).

(ii) Furthermore, if the partner borrows money for use outside of the activity, giving as security therefor property used in the activity or the partner's interest in the partnership, the partner's at risk basis in the activity is decreased by an amount equal to the amount so borrowed. Prop. Reg. §1.465-25(b)(1)(ii).

(2) To the extent that a taxpayer is personally liable for repayment of a liability, then the taxpayer's amount at risk in an ac-
tivity is increased by the amount of that liability incurred in the conduct of an activity for use in the activity. Prop. Reg. §1.465-24(a)(1).

(a) If the partnership incurs a liability in the conduct of an activity and under state law partners may be held personally liable for repayment of the liability, each partner’s amount at risk is increased to the extent the partner is not protected against loss. Prop. Reg. §1.465-24(a)(2)(i).

(i) To the extent the partner is protected against loss, then the liability is treated as an amount borrowed for which the taxpayer has no personal liability and for which no security is pledged. Prop. Reg. §1.465-24(a)(2)(i).

(ii) A right of contribution from other partners is considered as protection against loss, whether or not the other partners from whom contribution may be sought are solvent or otherwise able to meet their obligations. See, in contrast, Rev. Rul. 69-223, 1969-1 C.B. 184, holding that indemnification rights among partners do not affect basis.

(b) Repayment of a liability for which the taxpayer is personally liable does not affect the amount at risk. Prop. Reg. §1-465-24(b)(1)(i).

(i) The question of whether the taxpayer is personally liable is determined at the time of repayment. Prop. Reg. §1.465-24(b)(1)(i).

(ii) There is no impact on the amount at risk at the time of repayment even though, prior to such repayment, the taxpayer might not have been considered at risk because, until such time of repayment, the taxpayer was not considered to be personally liable.

(iii) There is an ambiguity here, for, if the amount was not considered at risk under Prop. Reg. §1.465-25 because there was no personal liability and no assets not used in the activity were pledged as security, then repayment of the loan by the taxpayer will, under Prop. Reg. §1.465-25(b)(2)(i), increase the taxpayer’s amount at risk to the extent of the repayment.

(c) Repayment of a liability which gave the taxpayer at risk basis with an amount which would not increase the taxpayer’s at risk amount if contributed to the activity will decrease the taxpayer’s at risk basis. Prop. Reg. §1.465-24(b)(2).

(i) This is the case where the assets used for repayment are already in the activity, and decreases the at risk amount by the adjusted basis (as defined in Prop. Reg. §1.465-23(b)(1)) of such assets.

(ii) This is the case where a loan with personal liability is repaid with funds received from a non-recourse loan secured by property used in the activity.

(iii) This is also the case where the partnership pays the liability and such partnership payment decreases the partner’s basis in the partnership under Sec. 733, I.R.C.

(3) A partner’s amount at risk in an activity is increased
by the personal funds contributed by the partner to the activity. Prop. Reg. §1.465-22(a).

(a) In a surprising move, Prop. Reg. §1.465-22(a) goes on to say that "a partner's amount at risk shall not be increased by the amount which the partner is required under the partnership agreement to contribute until such time as the contribution is actually made." This appears directly to contradict Reg. §1.752-1(e), which provides that, in the case of a limited partnership, a limited partner's share of partnership liabilities may be up to "the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement."

(b) Furthermore, Prop. Reg. §1.465-22(a) states that a partner's amount at risk is not increased by a recourse note payable to the partnership "until such time as the proceeds of the note are actually devoted to the activity."

(i) What if an amount is borrowed from an independent third party, using the partner's recourse note as security? Are the proceeds of the note then actually devoted to the activity?

(ii) What if the partner's note is secured by a third party bank's irrevocable letter of credit? Does that move the partner's note payable out of Prop. Reg. §1.465-22(a) into Prop. Reg. §1.465-24(a)(1), as an amount for which the partner is personally liable for repayment.

(iii) What if the partner's note is used as security for the acquisition of property from a third party? Is the partner then personally liable, so as to fall within Prop. Reg. §1.465-24(a)(1)?

(4) A partner's amount at risk in an activity is increased by the excess of the partner's share of income of the activity over the partner's share of the allowable deductions allocable to the activity. Prop. Reg. §1.465-22(c)(1).

(a) This includes tax-exempt receipts of the activity. Prop. Reg. §1.465-22(c)(1).

(b) In turn, the amount at risk is reduced by partnership distributions (Prop. Reg. §1.465-22(b)), allowable losses (Prop. Reg. §1.465-22(c)(2)) and amounts used by the partnership to repay loans (Prop. Reg. §1.465-25(a)(2)).