An Overview of Partnerships (PowerPoint)

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• A partner’s outside basis in its partnership interest
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Contributions and distributions
Contributions
General rules

- **Nonrecognition**—Subject to a number of exceptions discussed in this presentation, section 721(a) protects both the partnership and its partners from recognizing any gain or loss on the transfer of property to a partnership in exchange for an interest. Any gain or loss inherent in the contributed property is deferred until the contributed property or partnership interest is sold in a taxable transaction. See, e.g., section 704(c) discussed later in this presentation.

- **No control requirement**—Unlike section 351, there is no requirement that the contributing partners be in “control” of the partnership immediately after the contribution.

- **Exchange basis in partnership interest**—Under section 722, each contributing partner holds its partnership interest with an adjusted basis (outside basis) equal to the adjusted basis of the contributed property plus any cash contributed, i.e. the partnership interest has an exchanged basis (contributing partner’s outside basis is determined by reference to the contributing partner’s basis in the contributed property). See section 7701(a)(43).

- **Transferred basis in contributed property**—Under section 723, the partnership will hold the contributed property with an adjusted basis (inside basis) equal to the contributing partner’s adjusted basis in the contributed property increased by the amount (if any) of gain that the contributing partner recognized under section 721(b), i.e. the contributed property has a transferred basis (the partnership’s inside basis is determined by reference to the contributing partner’s in the contributed property). See section 7701(a)(44).
Common exceptions to nonrecognition

- **Section 721(c):** Special rules that are applicable when a US person transfers built-in gain property to a partnership with related foreign partners

- **Section 731(a) and 752:** If a partner contributes encumbered property, or the partnership assumes a partner’s liability, there is a deemed distribution of cash under section 752(b) that could result in gain under section 731(a)

- **Section 707(a)(2)(B):** Related contributions to, and distributions from, the partnership can be recast as a disguised sale

- **Treas. Reg. § 1.337(d)-3:** Special rules that apply when a partnership, either directly or indirectly, acquires, owns, or distributes stock of a corporate partner (but there is an exception when the partnership is wholly owned by members of the same affiliated group)

- **Section 721(b):** An exception to nonrecognition when a partner contributes property to an “investment partnership”
Distributions
General rules

- **Nonrecognition**: Subject to numerous exceptions, a partner will not recognize gain or loss with respect to a distribution unless the partnership distributes “money” in excess of the partner’s outside basis. In these instances, the partner will recognize gain to the extent the amount of “money” exceeds the partner’s outside basis. See section 731(a)(1).

  A partner can only recognize loss in connection with a liquidation distribution provided that (i) the partnership only distributes cash, unrealized receivables, and inventory, and (ii) the amount of cash, plus the basis of the distributed property in the partner’s hands, is less than the partner’s outside basis. See section 731(a)(2).

- **Basis in distributed property—Current distribution**: Partner will hold the distributed property with the same basis as the partnership immediately before the distribution, but the basis of the property in the partner’s hands cannot exceed the partner’s outside basis (reduced by any cash distributed in the same transaction). See section 732(a).

- **Basis in distributed property—Liquidating distribution**: Partner will hold the distributed property with a basis equal to the partner’s outside basis (reduced by any cash distributed in the same transaction). Unlike a current distribution, property may be “stepped up” in a liquidating distribution. See sections 732(b) and (c).
Common exceptions to nonrecognition

- **Section 707(a)(2)(B):** Related contributions to, and distributions from, the partnership can be recast as a disguised sale
- **Section 704(c)(1)(B):** Distribution of section 704(c) property to a noncontributing partner
- **Section 737:** Distribution of other property to a partner that previously contributed section 704(c) property
- **Section 751(b):** Distributions that change the partners’ shares of the partnership’s “hot assets”
- **Section 731(c):** Distributions of “marketable securities”
- **Treas. Reg. § 1.337(d)-3:** Special rules that apply when a partnership, either directly or indirectly, acquires, owns, or distributes stock of a corporate partner (but there is an exception when the partnership is wholly owned by members of the same affiliated group)
Section 707(a)(2)(B)
Background of Section 707(a)(2)(B) – Disguised Sale

Very generally, contributions of property to a partnership in exchange for an interest in the partnership and distributions of property by a partnership to its partners do not result in the recognition of gain or loss

One exception to these general rules is section 707(a)(2)(B), which provides that under regulations prescribed by the Secretary, if

i. there is a direct or indirect transfer of money or other property by a partner to a partnership,

ii. there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

iii. the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers will be treated either as a transaction between the partnership and one who is not a partner or as a transaction between two or more partners acting other than in their capacity as members of the partnership
Background of Section 707(a)(2)(B) – Disguised Sale (cont.)

Three types of disguised sales

• Sale of property by a partner to the partnership
• Sale of property by a partnership to a partner
• Sale of partnership interests among partners or other persons

Regulations under section 707 provide significant guidance, including

• A general facts and circumstances test and presumptions for transfers made within two years and more than two years apart (Treas. Reg. § 1.707–3(b), (c), and (d)),
• Exceptions and additional presumptions, and
• Detailed rules regarding the treatment of liabilities, which contain an exception for debt-financed transfers (Treas. Reg. § 1.707–5)
Disguised sales (cont.)

Example

Property
FMV—$400m
Tax—$120m

$300 cash + LLC Interest

LLC interest

$200 cash
Disguised sales (cont.)

Example (cont.)

 Sale transaction

X

Section 721 Transaction

1/4 Property 1
Basis $30
FMV $100

LLC interest

Y

3/4 Property 1
Basis $90
FMV $300

$300 Cash

LLC

Transaction

$300 Cash

• Determines whether an assumption of, or transfer of property subject to, a liability is treated as a transfer of consideration in a sale of property based on the characterization of a liability as “qualified” or “nonqualified”

• “Qualified” liabilities include only those liabilities described in Treas. Reg. § 1.707-5(a)(6) (and Treas. Reg. § 1.707-6(b)(2)(iii)); “nonqualified” liabilities include all other liabilities

• If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale, the partnership’s assumption of or taking subject to a qualified liability in connection with a transfer of property is not treated as part of a sale

• If the partnership assumes or takes property subject to a liability of the partner other than a qualified liability, the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner’s share of that liability immediately after the partnership assumes or takes subject to the liability
Debt-Financed Distributions

Partnership incurs a liability and transfers all or a portion of the proceeds of that liability to one or more partners

General disguised sale considerations

• Whether the distribution is being made in connection with contributions to the partnership
• Extent to which debt-financed-distribution exception applies
• Extent to which other disguised sale exceptions and presumptions apply
Debt-Financed Distributions (cont.)

- LLC borrows $500 from Bank. The loan is nonrecourse to X and Y
- LLC allocates the loan under Treas. Reg. § 1.752-3 equally to X and Y
- LLC distributes $500 to Y. This distribution increases X’s interest to 62.5% and decreases Y’s interest to 37.5%
Debt-Financed Distributions (cont.)

**Treas. Reg. § 1.707-5(b)(1) (debt-financed distribution exception)**

- If a partner transfers property to a partnership, and

- The partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Treas. Reg. § 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, then

- The transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability

**There are specific rules for determining a partner’s allocable share for purpose of debt-financed distribution exception**
Debt-Financed Distributions (cont.)

Partner's Share of Partnership Liabilities

Temp. Treas. Reg. § 1.707-5T(a)(2): For purposes of Treas. Reg. § 1.707-5, a partner's share of a liability of a partnership, as defined in Treas. Reg. § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under Treas. Reg. § 1.752-3(a)(3) (as limited in its application to this paragraph (a)(2)), but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of Treas. Reg. § 1.752-3(a)(3) to this paragraph (a)(2)).

Prop. Treas. Reg § 1.707-5(a)(2): Partner's share of liability. A partner's share of any liability of the partnership is determined under the following rules -

(i) Recourse liability. A partner’s share of a recourse liability of the partnership equals the partner’s share of the liability under the rules of section 752 and the regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability under Treas. Reg. § 1.752–1(a)(1) or would be treated as a recourse liability under that section if it were treated as a partnership liability for purposes of that section.

(ii) Nonrecourse liability. A partner’s share of a nonrecourse liability of the partnership is determined by applying the same percentage used to determine the partner’s share of the excess nonrecourse liability under Treas. Reg. § 1.752–3(a)(3). A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability under Treas. Reg. § 1.752–1(a)(2) or would be a nonrecourse liability of the partnership under Treas. Reg. § 1.752–1(a)(2) if it were treated as a partnership liability for purposes of that section.
Debt-Financed Distributions (cont.)

Treas. Reg. § 1.707-5(b)(2)(iii) (anticipated reduction rule)

• A partner’s share of a liability is determined by taking into account a subsequent reduction in the partner’s share if
  − (A) At the time that the partnership incurs the liability, it is anticipated that the partner's share of the liability that is allocable to a transfer of money or other consideration to the partner will be reduced subsequent to the transfer;
  − (B) The anticipated reduction is not subject to the entrepreneurial risks of partnership operations; and
  − (C) The reduction of the partner’s share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the partnership’s distribution of the proceeds of the borrowing is treated as part of a sale.
Debt-Financed Distributions (cont.)

- $90 loan
- Note

Assets
- FMV 100
- A/B 0
- 10% common
- $90

Assets
- FMV 90
- A/B 0
- 90% Common

Guarantee

LLC

Bank
Debt-Financed Distributions (cont.)
Exception for Reimbursements of Preformation Expenditures

• Treas. Reg. § 1.707–4(d) excepts transfers of money or other consideration from a partnership to reimburse a partner for certain capital expenditures and costs incurred by the partner from being treated as part of a disguised sale of property under Treas. Reg. § 1.707–3, subject to the 20 percent limitation and the 120 percent test

• In general, the determination of whether the 20 percent limitation and the 120 percent test apply to reimbursements of capital expenditures is made, in the case of multiple property transfers, separately for each property that qualifies for the exception

• If capital expenditures were funded by the proceeds of a qualified liability that a partnership assumes or takes property subject to in connection with a transfer of property to the partnership by a partner, a transfer of money or other consideration by the partnership to the partner is not treated as made to reimburse the partner for such capital expenditures to the extent the transfer of money or other consideration by the partnership to the partner exceeds the partner's share of the qualified liability
Exception for Reimbursements of Preformation Expenditures (cont.)

Preformation Capital Expenditures — Treas. Reg. § 1.707-4(d)(1)

The Final Regulations clarify that the 20 percent limitation and the 120 percent test apply on a property-by-property basis subject to a limited aggregation rule.

<table>
<thead>
<tr>
<th>Other Business</th>
<th>Tangible Asset</th>
<th>LLC</th>
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<tbody>
<tr>
<td>Tax Basis $100,000</td>
<td>Tax Basis $450,000</td>
<td>Capital Expenditure $130,000</td>
</tr>
<tr>
<td>FMV $100,000</td>
<td>FMV $550,000</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Business</th>
<th>Tangible Asset</th>
<th>Cash</th>
<th>Partners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited to $110,000</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>
Exception for Reimbursements of Preformation Expenditures (cont.)

**Preformation Capital Expenditures — Treas. Reg. § 1.707-4(d)(4)**

Treas. Reg. § 1.707-4(d)(4) treats only $10 of the reimbursement as a qualified reimbursement. Thus, the economic benefit to X is limited to $100 (net decrease in debt of $90, and reimbursement of $10). The remaining $90 of reimbursement, would not qualify under Treas. Reg. § 1.707-4(d).
Section 704(c)(1)(B)
If a partner contributes appreciated or depreciated property to a partnership, and that property is distributed to another partner within seven years, the contributing partner recognizes its remaining section 704(c) amount as if the partnership sold the property for its FMV at the time of the distribution.
Section 704(c)(1)(B) (cont.)

• Contributing partner’s outside basis in its partnership interest is:
  – Increased or decreased by recognized gain or loss
  – Increased or decreased as provided in section 705 (i.e., consider change in share of liabilities and adjustments required under section 733)

• Partnership inside basis of contributed property to be distributed is increased or decreased by recognized gain or loss
  – Increase or decrease to basis occurs immediately before property is distributed

• Basis of distributed property in the hands of the distributee partner is determined under section 732
Section 704(c)(1)(B) (cont.)

Example

• In year 1, X contributes Property X

• In year 4, when Property X’s value and basis have not changed, Partnership distributes Property X to Y

• X recognizes $150 of gain under section 704(c)(1)(B)
Section 704(c)(1)(B) (cont.)

Exceptions

• Distribution to contributing partner
• Property received in nonrecognition transaction for previously-contributed property
• Like-kind exchanges
• Complete transfer to another partnership followed by complete liquidation of transferor partnership
• Incorporation of partnership
Section 737
Section 737

• Section 737 triggers gain to a contributing partner on a distribution of other property to such partner

• Only applies to contribution and distribution within seven years of each other

• Gain = lesser of:
  - FMV of distributed property in excess of outside basis
  - Partner’s “net precontribution gain”
Section 737 (cont.)
Net pre-contribution gain

• “Net pre-contribution gain”:
  - The net gain a partner would recognize under section 704(c)(1)(B) if all properties contributed by the distributee partner within seven years had been distributed to another partner

• The character of the gain is determined proportionately by reference to the character of the net pre-contribution gain
Section 737 (cont.)
Effect on basis

• Contributing partner’s outside basis in its partnership interest is:
  − Increased by recognized gain
  − Increased or decreased as provided in section 705 (i.e., consider change in share of liabilities and adjustments required under section 733)
• Partnership’s inside basis of contributed property is increased by recognized gain
• Basis of distributed property in the hands of the distributee partner is determined under section 732
In year 1, X contributes Property X and Y contributes Property Y.

In year 4, when asset values and bases have not changed, Partnership distributes Property X to Y.

Y recognizes $50 of gain under section 737 (the lesser of (i) Y’s remaining section 704(c) gain of $150, and (ii) the excess of $150 over $100 basis).

What if X’s property was also section 704(c) property?
Distributive share
Distributive share

- **Section 704(a):** A partner’s distributive share of income, gain, loss or deduction is determined by the partnership agreement.

- **Section 704(b):** However, if (i) the partnership agreement does not provide as to the partner’s distributive share of income, gain, loss, or deduction, or (ii) the allocation to a partner under the agreement of income, gain, loss, or deduction does not have substantial economic effect, then a partner’s distributive share of income, gain, loss, or deduction shall be determined in accordance with the partner’s interest in the partnership.

  - **Substantial Economic Effect:** The substantial economic effect test provides a safe harbor. If an allocation is substantial and has economic effect, it should be respected.
    - **Economic Effect:** The economic effect test is mechanical and has three requirements:
      - Capital Account Requirement
      - Liquidation Requirement
      - Deficit Restoration Obligation Requirement
    - **Substantiality:** The substantiality test is much more subjective, and the partners must be able to demonstrate that the special allocation has some effect other than tax savings.

  - **Partner’s Interest in the Partnership:** If an allocation falls outside of the substantial economic effect safe harbor, it will be reallocated in accordance with the partner’s interest in the partnership. In general, this means that the item will be allocated to those partners who are actually bearing the economic burden, or enjoying that economic benefit, of that item, i.e. a facts and circumstances test.
Economic effect
Economic effect
Capital account requirement

- **Capital account requirement**: Partner’s must maintain section 704(b) capital accounts in accordance with the rules under Treas. Reg. § 1.704-1(b)(2)(iv)

- **General rules**: Very generally, the partners’ section 704(b) capital accounts reflect the financial relationship among the partners and the adjustments to these accounts reflect the manner in which the partners have agreed to share the profits and losses from their venture, i.e. they should reflect the partners’ economic deal

  - Partners Increase their Capital Accounts for...
    - Cash contributions
    - Fair market value of property contributed (net of liabilities assumed or taken subject to)

  - Partners Decrease their Capital Accounts for...
    - Cash distributions
    - Fair market value of property distributed (net of liabilities assumed or taken subject to)

**Note**: Absent a revaluation, the partners should not adjust their capital accounts for changes in the fair market value of the partnership’s property.
Economic effect (cont.)
Capital account requirement—Example

X and Y form partnership XY
X contributes $60 and Y contributes $40
Economic effect (cont.)
Capital account requirement—Example (cont.)

• XY buys asset for $100. Asset has a 10-year depreciable life, generating $10 of depreciation per year
• XY agreement allocates net profits and losses as follows:
  − Net losses are allocated first 90% to X and 10% to Y until X’s capital account is reduced to zero. Thereafter, all losses are allocated to Y
  − Net profits are first allocated in a manner to reverse prior loss allocations and then split 60% to X and 40% to Y
• At beginning of year 5, the asset is sold for $200 generating $140 of gain
Economic effect (cont.)
Capital account requirement—Example (cont.)

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Capital Accounts</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>Year 1—Depreciation</td>
<td>(9)</td>
<td>(1)</td>
</tr>
<tr>
<td>Year 2—Depreciation</td>
<td>51</td>
<td>39</td>
</tr>
<tr>
<td>Year 3—Depreciation</td>
<td>(9)</td>
<td>(1)</td>
</tr>
<tr>
<td>Year 4—Depreciation</td>
<td>33</td>
<td>37</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>24</td>
<td>36</td>
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</tbody>
</table>
Economic effect (cont.)
Capital account requirement—Example (cont.)

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital accounts at end of year 4</td>
<td>24</td>
<td>36</td>
</tr>
<tr>
<td>Year 5 gain on sale (1st allocation)</td>
<td>36</td>
<td>4</td>
</tr>
<tr>
<td>Year 5 gain on sale (2nd allocation)</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>Liquidating distributions</td>
<td>(120)</td>
<td>(80)</td>
</tr>
<tr>
<td><strong>Ending capital accounts</strong></td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>
Economic effect (cont.)

Liquidation requirement

- **General rule**: Upon liquidation of the partnership or a partner’s interest in the partnership, liquidating distributions will be made in accordance with the (properly maintained) positive capital account balances of the partners, taking into account all necessary adjustments to the partners’ capital accounts for the taxable year of such liquidation.

- **Targeted allocations**: Targeted allocations provide that the partnership will make liquidating distributions according to the distribution provisions of the agreement, rather than according to the partners’ positive capital account balances.
Economic effect (cont.)
Deficit restoration obligation requirement

- If after liquidation any partner has a deficit in its capital account, that partner must be unconditionally obligation to restore that deficit.
- This requirement can be satisfied by a clause in the partnership agreement, or an unconditional obligation imposed under state or local law.
- Because the partner must at some point contribute sufficient capital to eliminate any deficit, that partner is truly bearing the burden of any losses or deductions.
Alternate test for economic effect

Basics

- The partnership agreement satisfies the Capital Account and Liquidation Requirements

- If the partner has not agreed to an unlimited deficit restoration obligation, allocations to that partner will still have economic effect provide that an allocation does not reduce the partner’s capital account below zero or to a negative balance that exceeds any limited additional amount that the partner has, in all events, agreed to contribution to the partnership upon the partnership’s liquidation or the liquidation of the partner’s interest

- This limited restoration obligation must be memorialized in the agreement, i.e. a qualified income offset provision
Substantiality
Substantiality

Overview

- **In general:** In order for an allocation to fall within the substantial economic effect safe harbor, the partner’s must demonstrate that an allocation has some effect other than tax savings, i.e. the economic effect of the allocation must be substantial.

- **One test, three exception:** The economic effect of an allocation is substantial only if satisfies a general rule, and does not run afoul of three exceptions.
  - General rule
  - After-tax exception
  - Shifting exception
  - Transitory exception
A partner’s outside basis in its partnership interest
Overview
Why do we care about outside basis?

- A partner’s outside basis affects the partner’s
  - Ability to deduct its distributive share of partnership losses [section 704(d)]
  - Gain or loss with respect to distributions from the partnership [section 731]
  - Basis of property received in distributions from the partnership [section 732]
  - Gain or loss from the sale of its partnership interest [section 741]
## Determining outside basis

### Initial considerations

<table>
<thead>
<tr>
<th>Method of acquiring interest</th>
<th>Initial basis to recipient</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Purchase</td>
<td>• Partner holds its partnership interest with an outside basis equal to (i) cost, plus (ii) the partner’s share of the partnership’s liabilities.</td>
</tr>
<tr>
<td>• Contribution of property</td>
<td>• Partner holds its partnership interest with an outside basis equal to (i) the adjusted basis of the property contributed (exchange basis), plus (ii) the partner’s share of the partnership’s liabilities.</td>
</tr>
</tbody>
</table>
Determining outside basis

Changes to outside basis

• Increased by the adjusted basis of subsequent contributions by the partner
• Increased by the partner’s distributive share of profits from the partnership
• Decreased by the partner’s distributive share of losses from the partnership
• Decreased by the adjusted basis of distributions by the partnership to the partner
Determining outside basis
Ordering rules

+ Contributions of money or property
+ Partner’s distributive share of taxable and tax-exempt income
  - Partner’s distributive share of the partnership’s losses
  - Partner’s distributive share of the partnership’s nondeductible, noncapitalizable expenditures
Determining outside basis

Limitations

• A partner’s outside basis cannot be reduced below zero.
  - If a partner receives a distribution of cash in excess of its outside basis, the partner recognizes gain under section 731(a) equal to the difference.
  - A partner may only deduct its distributive share of partnership losses to the extent of the partner’s outside basis under section 704(d). Any excess losses are suspended and carried forward to future years.

• A partner is required to determine its outside basis only when necessary for the determination of its tax liability. Treas. Reg. § 1.705-1(a)(1). However, the partner may only adjust its outside basis for its distributive share of current year profits and loss at the end of the partnership’s taxable year, or when the partner’s taxable year closes with respect to the partnership, i.e. when there is a liquidating distribution, or the partner sells its entire interest. Section 706(a). Query what happens in the case of a current distribution or a partial sale?
Effect of a partnership’s liability on a partner’s outside basis
In general
Partnership liabilities
What is a liability for purposes of Subchapter K?

• An obligation is a liability only if the obligation (i) creates or increases the basis of the partnership’s assets (including cash), (ii) gives rise to an immediate deduction to the partnership, or (iii) gives rise to a nondeductible, noncapitalizable expenditures. Treas. Reg. § 1.752-1(a)(4)(i).

• An obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Treas. Reg. § 1.752-1(a)(4)(ii).
Partnership liabilities

Effect on a partner’s outside basis

• As a partner’s share of the partnership’s liabilities increases:
  - The amount of the increase is treated as a deemed cash contribution
  - This deemed cash contribution increases the partner’s outside basis

• As a partner’s share of the partnership’s liabilities decreases:
  - The amount of the decrease is treated as a deemed a cash distribution
  - This deemed cash distribution decreases the partner’s outside basis

• The partner recognizes gain under section 731(a) to the extent that the deemed cash distribution exceeds the partner’s outside basis

• The partner’s share of the partnership’s liabilities depends on whether the liabilities are recourse or nonrecourse
Partnership liabilities
Recourse vs. Nonrecourse

**Recourse liabilities**
- A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability.
- In addition to other rules, a partner or related person will bear economic risk of loss if they are the lender.
- For purposes of determining outside basis, a partner is allocated a recourse liability to the extent that partner (or a person related to that partner) bears economic risk of loss.

**Nonrecourse liabilities**
- A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability.
- For purposes of determining outside basis, a partner is allocated a nonrecourse liability under a complex, three-tier rule in the regulations.
Recourse liabilities
Recourse liabilities
Determining a partner’s share

• Partners share partnership nonrecourse liabilities in the same way that they share the economic risk associated with that liability.

• In making that determination, the regulations posit a disaster scenario, called a “constructive liquidation” during which the following events are deemed to occur:
  − All partnership liabilities become due and payable in full;
  − All partnership assets become worthless (including cash);
  − All partnership assets are disposed of in taxable transactions for no consideration;
  − The partnership allocates all items of income, gain, loss, or deduction for its last taxable year ending of the date of the constructive liquidation; and
  − The partnership liquidates.

• Following this constructive liquidation, if, and to the extent, that partner (or related person) is ultimately responsible for paying a partnership liability, either directly to the creditor or by way of a contribution to the partnership, that partner bears economic risk of loss and shares in the liability to that extent.

• Importantly, the regulations assume that all parties, regardless of net worth or financial condition, live up to their obligations.

• A partner bears the economic risk of loss for a partnership liability if a person related to the partner bears the economic risk of loss, e.g. there is a related party lender.
Recourse liabilities (cont.)

Example

X

Land

FMV—$10,000
Basis—$ 2,000
Liab.—$ (3,000)

GP

Cash

$7,000

Y

50% Partner
Basis = ?

50% Partner
Basis = ?
Recourse liabilities (cont.)
Example (cont.)

50% Partner
Basis $2,000 - 3,000 + 1,500
= $500

50% Partner
Basis = ?
Recourse liabilities (cont.)

Example (cont.)

What if the partnership were an LLC?
Nonrecourse liabilities
Nonrecourse liabilities
Sharing rules

• Nonrecourse debt is shared in the following order:

  1. According to each partner’s share of section 704(b) “minimum gain”

  2. According to each partner’s share of section 704(c) “minimum gain”

  3. According to each partner’s profit sharing ratio, or according to how each partner expects to share nonrecourse deductions, or according to how an item of partnership income or loss is shared
Nonrecourse liabilities (cont.)
First tier minimum gain

• Very generally, section 704(b) minimum gain is the amount of book gain that the partnership would allocate a partner if the partnership disposed of the property that is subject to the liability in question for no consideration other than full satisfaction of the liability.

• Does the amount of debt exceed the book value of property?
Nonrecourse liabilities (cont.)
Second tier minimum gain

Amount of any taxable gain that would be allocated to a partner under section 704(c) if the partnership disposed of (in a taxable transaction) the partnership property subject to the nonrecourse liability in full satisfaction of the liability and for no other consideration.
Nonrecourse liabilities (cont.)
Third tier profit sharing ratio

• Allocate according to:
  − Each partner’s profit sharing ratio, or
  − How each partner expects to share nonrecourse deductions, or
  − How an item of partnership income or loss is shared
Nonrecourse liabilities (cont.)
Example

X

Land

FMV—$10,000
Basis—$ 2,000
Nonrecourse Liab.—$ 3,000

LLC

Cash

$7,000

Y

50% Partner
Basis = ?

50% Partner
Basis = ?
Nonrecourse liabilities (cont.)
Example (cont.)

X

FMV—$10,000
Basis—$2,000
Nonrecourse Liab.—$3,000

Land

LLC

Y

Cash

$7,000

50% Partner
Basis $2,000 – 3,000 + 1,000 + 1,000 = $1,000

50% Partner
Basis = ?
Nonrecourse liabilities (cont.)
Example (cont.)

50% Partner
Basis = $1,000

50% Partner
Basis = $7,000 + 1,000 = $8,000

FMV—$10,000
Basis—$ 2,000
Nonrecourse Liab.—$ 3,000

X

Land

Y

Cash

$7,000

LLC
Special rules for built-in gain or loss property
Section 704(c)

- **In general:** Section 704(c)(1)(A) provides that “income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take into account the variation between the basis of the property to the partnership and its fair market value at the time of contribution.”
  - In other words, when built-in gain or loss property is contributed to a partnership, the built-in gain or loss (when realized by the partnership) must be taken into account for tax purposes by the contributing partner.
  - These principles also apply to partnership revaluations.

- **Methods:** The statute defers to the Secretary for guidance on how this should be accomplished. The regulations therefore state that a partnership may use a “reasonable method which is consistent with the purposes of section 704(c)” and go on to identify three methods that Treasury and the IRS generally will find reasonable.
  - Traditional method
  - Traditional method with curative allocations
  - Remedial allocation method

- **Remember:** Section 704(c) is applied on a property-by-property basis (subject to very narrow exceptions).
Traditional method
Traditional method

• **Mechanics**
  - Allocate book items in accordance with agreement.
  - Allocate corresponding tax items first to the noncontributing partner until the noncontributing partner has been allocated an amount of corresponding tax items equal to the book items.
  - Once the noncontributing partner has been allocated corresponding tax items equal to the book items, all remaining tax items are allocated to the contributing partner.

• **Ceiling rule:** The ceiling rules provides that the total amount of tax items allocated to a noncontributing partner for a taxable year with respect to section 704(c) property cannot exceed the total amount of the tax items that are actually recognized by the partnership for such year. As a result, the noncontributing partner will be shifted (at least temporarily) some portion of the tax consequences attributable to the built-in gain or loss associated with the section 704(c) property.
Example

• Equipment has 2 years depreciable life remaining. It will generate $100 of section 704(b) book depreciation and $20 of tax depreciation each year
Example (cont.)

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th></th>
<th>Y</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning capital</strong></td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>40</td>
</tr>
<tr>
<td><strong>Year 1 depreciation</strong></td>
<td>(50)</td>
<td>(20)</td>
<td>(50)</td>
<td>0</td>
</tr>
<tr>
<td><strong>Year 1 ending capital</strong></td>
<td>150</td>
<td>180</td>
<td>150</td>
<td>40</td>
</tr>
<tr>
<td><strong>Year 2 depreciation</strong></td>
<td>(50)</td>
<td>(20)</td>
<td>(50)</td>
<td>0</td>
</tr>
<tr>
<td><strong>Year 2 ending capital</strong></td>
<td><strong>100</strong></td>
<td><strong>160</strong></td>
<td><strong>100</strong></td>
<td><strong>40</strong></td>
</tr>
</tbody>
</table>
Traditional method with curative allocations
Traditional with curative allocations

• **In general:** Recognizing the problems caused by the ceiling rule, Treasury and the IRS permit partnerships to use the “traditional method with curative allocations.” Partnerships using this method may elect to make reasonable “curative allocations” to eliminate ceiling rule distortions, i.e. the partnership allocates tax items away from the contributing partner and to the non-contributing partner.

• **Special considerations:**

  – **Amount:** Curative allocations must be reasonable in amount. This means the curative allocation cannot exceed the amount needed to cure the ceiling rule limitation. However, a curative allocation does not have to cure the entire ceiling rule limitation.

  – **Type:** A curative allocation must be expected to have substantially the same effect on each partner’s tax liability as the tax items limited by the ceiling rule. For example, if depreciation deductions with respect to leased equipment contributed by a tax-exempt partner are limited by the ceiling rule, a curative allocation of dividend or interest income to that partner generally is not reasonable, although a curative allocation of depreciation deductions from other leased equipment to the noncontributing partner is reasonable.
• X’s $200 is used to purchase Asset 2 that is depreciable over 2 years on the straight-line method.
### Traditional with curative allocations (cont.)

**Example (cont.)**

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Beginning capital</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Year 1 Dep.—Equip</td>
<td>(50)</td>
<td>(20)</td>
</tr>
<tr>
<td>Year 1 Dep.—Asset 2</td>
<td>(50)</td>
<td>(80)*</td>
</tr>
<tr>
<td>Year 1 ending capital</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Year 2 Dep.—Equip</td>
<td>(50)</td>
<td>(20)</td>
</tr>
<tr>
<td>Year 2 Dep.—Asset 2</td>
<td>(50)</td>
<td>(80)*</td>
</tr>
<tr>
<td><strong>Ending capital</strong></td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

* Asset 2 tax depreciation is shared disproportionately to make-up ceiling limitation from equipment.
Remedial allocation method
Remedial allocation method

• **In general:** The remedial method is an alternative method of curing ceiling rule limitations. In essence, the remedial method permits partners to “ignore” the ceiling rule—tax allocations will always be available to match book allocations to the noncontributing partner because the partnership is permitted to manufacture them
  
  - Partnership creates a correcting “notional” item allocated to the noncontributing partner
  
  - Partnership creates an offsetting “notional” item allocated to the contributing partner

• **Special rule for book depreciation**
  
  - The portion of book basis equal to the adjusted tax basis of the contributed property is depreciated in the same manner as the adjusted tax basis
  
  - The excess of the book basis over the tax basis is depreciated as if it were newly purchased property
Remedial allocation method (cont.)

Example

• Same facts as traditional method example, except partners agree to use remedial allocation method.

$200 cash

50% interest

50% interest

Equipment
FMV = $200
Basis = $40

X

50%

XY Partnership

Y
Remedial allocation method (cont.)
Example (cont.)

**Depreciation table**

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th></th>
<th></th>
<th>Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Old</td>
<td>New</td>
<td>Total</td>
<td>Old</td>
<td></td>
</tr>
<tr>
<td>Beginning basis</td>
<td>40</td>
<td>160</td>
<td>200</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>Year 1 depreciation</td>
<td>(20)</td>
<td>(40)</td>
<td>(60)</td>
<td>(20)</td>
<td></td>
</tr>
<tr>
<td>Year 2 depreciation</td>
<td>(20)</td>
<td>(40)</td>
<td>(60)</td>
<td>(20)</td>
<td></td>
</tr>
<tr>
<td>Year 3 depreciation</td>
<td>0</td>
<td>(40)</td>
<td>(40)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Year 4 depreciation</td>
<td>0</td>
<td>(40)</td>
<td>(40)</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td><strong>Ending basis</strong></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

- “New” equipment depreciated over 4 years straight-line
Remedial allocation method (cont.)
Example (cont.)

<table>
<thead>
<tr>
<th></th>
<th>X</th>
<th>Y</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning capital</strong></td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td><strong>Year 1 depreciation</strong></td>
<td>(30)</td>
<td>(20)</td>
</tr>
<tr>
<td>Remedial Alloc—Year 1</td>
<td>-</td>
<td>(10)</td>
</tr>
<tr>
<td><strong>Year 2 depreciation</strong></td>
<td>(30)</td>
<td>(20)</td>
</tr>
<tr>
<td>Remedial Alloc—Year 2</td>
<td>-</td>
<td>(10)</td>
</tr>
<tr>
<td><strong>Year 3 depreciation</strong></td>
<td>(20)</td>
<td>0</td>
</tr>
<tr>
<td>Remedial Alloc—Year 3</td>
<td>-</td>
<td>(20)</td>
</tr>
<tr>
<td><strong>Year 4 depreciation</strong></td>
<td>(20)</td>
<td>0</td>
</tr>
<tr>
<td>Remedial Alloc—Year 4</td>
<td>-</td>
<td>(20)</td>
</tr>
<tr>
<td><strong>Ending capital</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>
Basis adjustments resulting from transfers
Section 743(b) adjustment

In general

- Based on an aggregate theory of partnership taxation
- Resulting basis adjustment only affects the transferee
- Generally requires a “sale or exchange” and a section 754 election
- Detailed rules for allocating adjustments under section 755
Section 743(b) adjustment (cont.)

Mechanics

• Determine amount of adjustment:

  - Increase adjusted basis of partnership property by the excess of transferee partner’s outside basis in the partnership over transferee partner’s share of the inside basis of partnership property

  - Decrease adjusted basis of partnership property by the excess of transferee partner’s share of the inside basis of partnership property over transferee partner’s outside basis in the partnership
Section 743(b) adjustment (cont.)
Calculation

- **Transferee’s basis in the transferred partnership interest, i.e. transferee’s outside basis**
  - Price paid, plus share of liabilities

- **Transferee’s share of the adjusted basis to the partnership of the partnership property, i.e. transferee’s share of inside basis**
  - Transferee’s interest in previously taxed capital, plus share of liabilities
  - What is previously taxed capital?
    - Hypothetical Transaction: Hypothetical transactions means the disposition by the partnership of all the partnership’s assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.
    - Formula
      - The amount of cash that the transferee would receive on a liquidation of the partnership following a “hypothetical transaction”
      - Plus, tax loss allocated to the transferee from the hypothetical transaction
      - Less, tax gain allocated to the transferee from the hypothetical transaction
Section 754 election
Example

- A is a member of partnership ABC. Each partner has an equal interest in capital and profits. The partnership has made an section 754 election. A sells its interest to T for $22,000. ABC’s balance sheet at the date of sale shows the following:

<table>
<thead>
<tr>
<th></th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$20,000</td>
<td>$21,000</td>
</tr>
<tr>
<td>Depreciable property</td>
<td>$20,000</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$55,000</strong></td>
<td><strong>$76,000</strong></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital—A</td>
<td>$15,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Capital—B</td>
<td>$15,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Capital—C</td>
<td>$15,000</td>
<td>$22,000</td>
</tr>
<tr>
<td><strong>Total liabilities and capital</strong></td>
<td><strong>$55,000</strong></td>
<td><strong>$76,000</strong></td>
</tr>
</tbody>
</table>
Section 754 election (cont.)
Example (cont.)

• T’s outside basis is calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price paid</td>
<td>$22,000</td>
</tr>
<tr>
<td>Share of liabilities</td>
<td>$3,333</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$25,333</strong></td>
</tr>
</tbody>
</table>

• T’s interest in previously taxed capital is calculated as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>How to calculate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received upon hypothetical transaction</td>
<td>$22,000</td>
<td>33.33%* ($76,000 total FMV less liabilities $10,000)</td>
</tr>
<tr>
<td>Less: Tax gain allocated to T from hypothetical transaction</td>
<td>$(7,000)</td>
<td>33.33%* ($76,000 total FMV less basis $55,000)</td>
</tr>
<tr>
<td><strong>Total previously taxed capital</strong></td>
<td><strong>$15,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
Section 754 election (cont.)
Example (cont.)

• T’s share of inside basis is calculated as follows:

<table>
<thead>
<tr>
<th>Total previously taxed capital</th>
<th>$15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of liabilities</td>
<td>$3,333</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$18,333</strong></td>
</tr>
</tbody>
</table>

• The basis adjustment under section 743(b) is calculated as follows:

<table>
<thead>
<tr>
<th>T’s outside basis</th>
<th>$25,333</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: T’s share of inside basis</td>
<td>$(18,333)</td>
</tr>
<tr>
<td><strong>Total basis adjustment</strong></td>
<td><strong>$7,000</strong></td>
</tr>
</tbody>
</table>
Section 743(b) adjustments

Tax consequences

• Partnership sale of property → basis adjustment increases or decreases partner’s gain or loss

• Positive basis adjustment = new depreciable or amortizable asset, depreciated/amortized over new tax life

• Negative basis adjustment → reduces basis of assets to calculate depreciation or amortization, depreciated/amortized over remaining tax life
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